1997-98, the fiscal deficit of the States as a proportion of GDP was around 3 percent and was under control. Since then, states were forced to run into huge fiscal deficits essentially because of rise in revenue deficits – state expenditure on salaries and pensions sky-rocketed directly due to Central Government measures arising out of the salary hikes on the basis of recommendations of the Fifth Pay Commission.

Secondly, the Centre has been directly responsible for the high interest rates of States public debt. Under the Indian Constitution, the Centre has the power to determine both the extent and the terms of borrowing by States from all sources, including the Centre itself. This power has been used/abused by the Centre against the states for the last many decades in various ways. One way is that the Centre charges high rates of interest on debt which it issues to the states – in fact, invariably the rate of interest for the states is higher than the rate at which the Centre itself has been paying.

Further, when State Governments raise debt provided by multi-national institutions like World Bank and ADB, they are charged a higher rate by the Central Government which is the intermediary – than the rate of interest charged by the international institutions.

Again, the Central Government has abused its constitutional powers to limit the ability of States to borrow from the market and from commercial banks and financial institutions.

Finally, State Governments which have a revenue deficit have to seek special permission from the RBI to borrow from commercial banks.

The result of these factors is that the average rate of interest which the States have to pay on their debt has remained relatively high – around 10 to 11 percent. At the same time, the average rate of interest paid by the Centre on its own debt has come down from about 9 percent to 6.5 percent. In other words, the Centre has always played the usurious moneylender to the States.

In the past, Finance Commissions have recommended schemes to reduce the volume of Central Government loans to the States.

The growing debt burden of the States has been a source of serious concern for the States and the Centre. With the active help of the Government of India, a Debt Swap Scheme was been formulated to liquidate high cost loans given by the Government of India to the States. The States have agreed to utilise 20 per cent of net small savings proceeds released from September 2002 to pre-pay high cost Government of India loans and advances.

The Twelfth Finance Commission has recommended a scheme of Debt Relief for the period 2005-10. The scheme envisages the rescheduling of all Central loans contracted till end-March 2004 and outstanding as on end-March 2005 into fresh loans for 20 years carrying 7.5 percent interest. This provision is conditional to a State enacting the Fiscal Responsibility Legislation. The implication are : (a) the States are irresponsible in their expenditure, (b) they do not mobilize resources themselves and (c) they themselves are responsible for their mounting public debt.

## Problems of Public Debt Policy

The Union Government is in a position to raise loans at slightly more favourable terms than the States. It is able to offer a lower rate for loans of longer maturity than the States. Further, there is a slight disparity in the terms at which different States can borrow. It has been suggested that the Union Government alone should raise loans from the market and should distribute the proceeds among the States according to their requirements.

Since Independence, the Central Government has set up a series of banking and financial institutions which indeed constitute a captive market for Government loans. We mean here the nationalised banks, statutory and public provident funds, LIC, GIC etc. This captive market is forced to absorb the huge amount of loans raised by the Centre.

# 8. DEFICIT FINANCING IN INDIA

Deficit financing has been used by the Government of India for acquiring funds to finance economic development. When the Government cannot raise enough financial resources through taxation, it finances its development expenditure through (a) by running down its cash balances with the Reserve Bank of India (b) borrowing from the market, and (c) borrowing from R.B.I. In this way, the Government acquires necessary finance to secure real resources for economic development.

The basic mistake the Finance Ministry formerly made was to regard borrowing from the market, and collection of small savings etc. as part of its capital receipts. It regarded borrowing from RBI alone as deficit financing. This mistake was committed since 1950-51. but it was rectified in recent years. At the outset, let us have a clear idea of different kinds deficits and financing of these deficits.

### (a) Revenue Deficit

Since 1950-51 the Government of India recognised only two types of deficits, viz., revenue deficit and overall budgetary deficit.

**Revenue Deficit = Revenue Receipts – Revenue Expenditure**

The concept of revenue deficit is a simple and straight one. Current revenue expenditure of the Central Government is composed of Plan and non-Plan expenditure of the Government, and is met out of current revenue receipts (which include net tax revenue[3] and non-tax

3. Net tax revenue and not gross tax revenue because part of the proceeds of the tax revenue is transferred to the States.

revenue of the Central Government). In Table 21, we have calculated that, in 1990-91:

Total revenue receipts = ₹ 54,950 crores
Total revenue expenditure = ₹ 73,510 crores
Revenue deficit = Revenue Receipts – Revenue Expenditure
= ₹ 54,950 crores – ₹ 73,510 crores
= ₹ – 18,560 crores

Let us calculate revenue deficit for the year 2011-12 :
Revenue Receipts of 2012-13 : ₹ 9,35,685 crores
Revenue Expenditure of 2012-13 : ₹ 12,86,109 crores

Revenue deficit for 2012-13 = 9,35,685 – 12,86,109
= ₹ – 3,50,424 crores

Revenue deficit (deficit is indicated by minus symbol) reflects the failure of the Government of India to meet its current expenditure from its current revenues.

Till the middle of the 1970's, the revenue receipts of the Central Government exceeded its revenue expendidture; accordingly, the Central Government enjoyed revenue surplus. Actually, on the recommendations of the Taxation Enquiry Commission (V T Krishnamachari Commission), the Government of India had adopted, at the time of the First Plan, a ***deliberate budgetary policy of revenue suplus*** which meant, creating excess of current receipts over current expenditure. This revenue surplus was to be achieved through deepening and widening of the tax base and thus increasing tax revenue on the one side and strict control of revenue expenditure on the other ( in other words, keeping the public expenditure under check). This surplus revenue was to be used to finance economic development under the Five Year Plans. Surplus budgeting was a laudable objective.

**Table 20 : Calculation of Fiscal and other Deficits**
*(₹ crores)*

| | 1990-91 *Actual* | 2012-13 Budget |
|---|---|---|
| **1. Revenue Receipts** | 54,950 | 9,35,685 |
| **2. Capital Receipts** | 39,010 | 5,55,241 |
| *of which* | | |
| (a) Loan recoveries and other receipts | 5,710 | 41,650 |
| (b) Borrowings and other liabilities | 33,300 | 5,13,590 |
| **3. Total Receipts (1+2)** | 93,960 | 14,90,925 |
| **4. Revenue Expenditure** | 73,510 | 12,86,109 |
| **5. Capital Expenditure** | 31,800 | 2,04,816 |
| **6. Total Expenditure** | 1,05,310 | 14,90,925 |
| *7. Revenue Deficit* (1–4) | 18,560 | 3,50,424 |
| *8. Budgetary Deficit* (3–6) | 11,350 | NIL |
| **9. Fiscal Deficit** {6–(1 +2 (a)} or 2(b) | 44,650 | 5,13,590 |

Note: Budget figures are rounded.
Source : *Budget at a Glance*, 2012-2013.

In a period of about two decades or so (1951-75), however, the objective of revenue surplus was gradually eroded because of ***continuous expansion of current expenditure***, particulary of the non-Plan category i.e., general administration, defence, interest payments and major and minor subsidies. This was, in spite of the enormous increase in tax receipts during the period. Accordingly, revenue deficit became a special feature of Central Government budgeting from the middle of the 1970s.

## (b) Budget Deficit

(b) Budget Deficit =
Total Receipts – Total Expenditure

Here total receipts include total revenue receipts and total capital receipts. In the same way, total expenditure is the addition of total current expenditure and total capital expenditure (or disbursements). In table 21, we have mentioned that in the year 1990-91 :

Total Receipts = ₹ 93,960
Total Expenditure = ₹ 105,310
Budget deficit = (–) 11,350

For the year 2012-13, we have calculated as follows

Budget Deficit = Total Receipts
(₹ 14,90,925 crores)
– Total Expenditure
(₹ 14,90,925 crores)
= Nil

Budget deficit, sometimes also referred to as over-all budget deficit, occurs when total expenditure exceeds total receipts, this was called deficit financing by the ministry of finance.. The Central Government met its over-all budgetary deficit by net sale of Treasury bills to the RBI. This led to printing of additional currency by RBI against Governments IOU, RBI gave the Govoernment its IOU, namely, its currency notes.

The whole concept of budget deficit or over-all budget deficit since 1950-51 and the method of covering it by borrowing from RBI through the sale of Treasury Bills was wrong. The basic mistake was the calculation of "capital receipts" by the Finance Ministry of the Government of India. According to the Finance Ministry, capital receipts are the sum of

(a) Recoveries of loans,
(b) other receipts, and
(c) borrowings and other liabilities

Really speaking, the third source – i.e. borrowing and other liabilities – are not receipts of the Government and should not be included under capital receipts. They are the liabilities of the Government, payable to the public. In other words, they also form part of the over-all budget deficit.

Accordingly the traditional concept of budget deficit financing was restrictive and it could just indicate only the extent of monetary deficit. B.R. Shenoy was the first economist to point out, as far back as 1954-55, ***the dangerous implications of regarding market borrowings and other capital receipts as part of Government receipts*** and taking only over-all budget deficit as deficit financing. The actual extent of deficit financing in any given year should include

(a) over-all budgetary deficit, *plus*

(b) market borrowings, small savings collections and other capital receipts which are actually liabilities.

B.R. Shenoy's warning was brushed aside by other economists and by the Government of India for a long time. It was finally left to the Sukhmoy Chakravarty Committee on the Working of the Monetary System in India to point out the inherent weakness of the definition of the budgetary deficit as deficit financing and the necessity to change the concept. The real deficit of the fiscal operations, the Committee emphasised, should ***include not only budgetary deficit but also market borrowings and other liabilities***. The Government of India accepted this recommendation of Sukhmoy Chakravarty Committee, (*a*) gave up the conventional concept of deficit financing and (*b*) started the calculation of a third concept of deficit, known as fiscal deficit from the year 1997-98.

## (c) Fiscal Deficit

In simple terms, ***fiscal deficit is budgetary deficit plus market borrowings and other liabilities of the Government of India***. In more clear terms,

Fiscal deficit = Revenue Receipts
+ Capital receipts (only recoveries of loans and other receipts)
—Total expenditure

OR

= Budget deficit + Government's market borrowings and liabilities

Let us illustrate the calculation of fiscal debt for the year 1990-91.

*(₹ crores)*

**Fiscal deficit in 1990-91**

= Revenue receipts for the year 1990-91 = 54,950
+ Capital Receipts in the form of recoveries of loans and other receipts in 1990-91 = 5,710
Total revenue in 1990-91 60,660
– Total Expenditure in 1990-91: 1,05,310
Fiscal deficit = 44,650

In the alternative formulation,

**Fiscal deficit in 1990-91**

= Budget deficit in 1990-91,
i.e. ₹ 11,350 crores + Market borrowing and other liabilities in 1990-91, i.e. ₹ 33,300 crores
= ₹ 44,650 crores

**Calculation of fiscal deficit for the year 2012-13,**

**Fiscal deficit** = Total expenditure for 2012-13, i.e. ₹ 14,90,925 crores – Total receipts (Revenue Receipts + Recoveries of loans and other receipts) ₹ 9,35,685 crores + ₹ 41,650 crores)
i.e. ₹ 9,77,335 crores
= 5,13,590 crores

OR **Fiscal deficit** = Budget deficit (Nil)
+ Market Borrowings and liabilities
(₹ 5,13,590 crores)

Fiscal deficit thus indicates ***the total borrowing requirements of the Government from all sources***. From the point of view of the economy, fiscal deficit is the most significant, since ***it shows the gap between Government receipts and Government expenditure***. It reflects the ***true extent of borrowing*** by the Government in a fiscal year. On the other hand, the conventional concept of budgetary deficit reflects only the Government's borrowing from RBI.

## Primary Deficit

In recent years the Finance Ministry has introduced one more concept of deficit known as "primary deficit" which does not have any policy significance.

Primary deficit = Fiscal deficit – Interest payments

In 2012-2013 budget, fiscal deficit was put at ₹ 5,13,590 crores and interest payments at ₹ 3,19,759 crores.

Accordingly

Primary deficit during 2012-13
= ₹ 5,13,590 crores – 3,19,759 crores
= ₹ 1,93,831 crores.

## Deficit Trends in recent years

Table 22 brings out the deficit trends in India in recent years.

(a) Revenue deficit has been rising quite fast — from ₹ 18,560 crores to ₹ 3,50,424 crores between 1991 and 2013. As percentage of GDP, revenue deficit had ranged between 3.5 to 5.3 per cent which was regarded as quite high. Such huge revenue deficit indicated clearly that the Government had been living beyond its means and that it had to cut its current expenditure – specially its non-plan expenditure — instead of looking for sources of additional taxation.

(b) Originally, budget deficit was calculated to show RBI lending to the Government. Since 1997 RBI lending to Government through *ad hoc* Treasury Bills was given up. The concept of budget deficit has lost its relevance.

(c) The Finance Ministry has so estimated the capital receipts that the ***total receipts of the Government are exactly equal to the total expenditure;*** there is, therefore, no over-all budget deficit.

(d) The Government has discontinued the issue of ***ad hoc treasury bills to*** RBI, but instead, it will tap 91 days treasury bills from the market. This would be ***part of the capital receipts*** under the heading "borrowings and other liabilities."

(e) Fiscal deficit has been growing rapidly and dangerously -- from ₹ 27,040 crores in 1988-89 to ₹ 44,630 crores in 1990-91 and to ₹ 5,13,590 crores in 2012-13 budget. The international financial institutions such as the World Bank and the IMF objected to the high rate of fiscal deficit (7.7 % of GDP) in 1990-91 and asked the Government of India to reduce it over the next few years. Accordingly, the Government reduced fiscal deficit as a percentage of GDP to 5.9 and 5.7 per cent in 1991-92 and 1992-93 respectively. During 1993-94, however, fiscal deficit rose to 7.4 per cent of GDP.

**Table 21: Deficit Trends**

*(₹ crores)*

| *Year* | *Revenue deficit* | *Fiscal deficit* | *Primary deficit* |
|---|---|---|---|
| 1990-91 | 18,560 (3.2) | 44,630 (7.7) | 23,130 (4.0) |
| 2007-08 | 52,569 (1.1) | 1,26,912 (2.5) | –44,118 (–0.9) |
| 2008-09* | 2,53,439 (4.5) | 3,36,992 (6.0) | 1,44,788 (3.2) |
| 2010-11(Actual) | 2,52,252 (3.3) | 3,73,591 (4.9) | 1,39,569 (1.8) |
| 2011-12(RE) | 3,94,951 (4.4) | 5,21,980 (5.9) | 2,46,362 (2.8) |
| 2012-13(B.E) | 3,50,424 (3.4) | 5,13,590 (5.1) | 1,93,831 (1.9) |

Note: Figures in brackets are estimated percentages of GDP.
Source: ***Economic Survey***, 2007-08, and previous issues ***Budget at a Glance***, 2012-13.

For many years, the Finance Ministers of the Government of India were not worried, as they could raise funds from the market, from the captive banks and other financial institutions. The RBI, however, has been warning the Government regularly of the impending debt trap. It was only when the World Bank and International institutions refused to bail out India in 1990-91 unless it reduced its fiscal deficit, that the Government was forced to take stringent measures to control non-plan expenditure.

The uncontrolled growth of revenue deficit is due to the sharp rise in non-plan expenditure, mainly on account of higher interest payments, rise in major subsidies and increase in pensions payments. It was the NDA Government that made a two-pronged attack in reducing revenue and fiscal deficits through augmenting revenue on the one side and controlling non-plan expenditure on the other. According to 2008-09 budget, fiscal dificit was projected to be 2.5. per cent of GDP. But in revised estimates for 2011-12, fiscal deficit turned out to be 5.9 percent of GDP. For Budget 2012-13, Fiscal Deficit has been kept at 5.1 percent of GDP.

## The Purpose of Deficit Financing in India

Deficit financing in India in the proper sense of fiscal deficit — was mainly adopted to enable the Government of India to obtain necessary resources for the Five-Year Plans. The levels of outlay laid down were of an order which could not be met only by taxation or through a revenue surplus.

The gap in resources is made up partly through external assistance but when external assistance is not enough to fill the gap, increased resort to borrowing has to be undertaken. The targets of production and employment in the plans are fixed primarily with reference to what is considered as the desirable rate of growth for the economy. When these targets cannot be achieved through resources obtained from taxation and external borrowing, additional resources have to be found. Borrowing from the market and from RBI comes in handy.

This was the position in India till the middle of 1970s. Since then, the Central Government gradually started incurring fiscal deficit i.e., market borrowings and borrowings from RBI (i.e., budgetary deficit) had to be used to cover current revenue deficit also. This is the dangerous aspect of the situation since it is bound to force the Government to land into a debt trap.

It is important to emphasise the fact that deficit financing cannot create real resources which do not exist in the economy. It is only a device which helps in the transfer of resources to the Government. The real resources required for economic development must exist in the form of raw materials, equipment, skill and labour. These things cannot be created by printing money or issuing bank credit.

### Effects of Deficit Financing

***(i) Fiscal deficit and expansion in public debt and other liabilities*** — In the last decade, fiscal deficit was rising very fast and consequently, the public debt and other liabilities of the Government of India were literally multiplying. For instance, the total amount of public debt and other liabilities of the Government of India were :

₹ 3,14,560 crores in 1990-91
₹ 9,90,260 crores in *1999-2000*
₹ 50,25,072 crores in 2012-13

In a matter of just 22 years, the volume of public debt and other liabilities of the Government of India has risen nearly 15.97 times or 1597 per cent. As a direct result of this growth of Government's total liabilities, the annual interest burden of the Government of India is also mounting, as for instance.

*Interest Burdent of the Governments of India*

| | |
|---|---|
| 1980-81 | ₹ 3,500 crores |
| 1990-91 | ₹ 21,500 crores |
| 1999-00 | ₹ 88,000 crores |
| 2012-13 | ₹ 3,19,759 crores |

The annual average growth rate of public debt was around 12.5 per cent during 1990-91 and 2012-13.

Nearly 47 percent of the current tax revenue of the Central Government goes towards payment of interest burden only. No wonder, the Government has to borrow heavily to meet revenue deficits.

*(ii) Inflationary rise in prices*. The most serious disadvantage of deficit financing is the inflationary rise of prices. Deficit financing increases the total volume of money supply in the country and, therefore, raises the aggregate demand for goods and services. In the absence of a corresponding increase in aggregate supply of goods and services, deficit financing leads to rise in the price level. It has been argued that deficit financing has been adopted in India for the purpose of development and that, therefore, increase in production will eventually check rise in prices. Besides, an appropriate policy of checking undue rise in prices may also help in bringing about economic stability.

When deficit financing goes too far, it becomes self-defeating. The rising prices are followed by rising costs and the latter cause further rise in prices, so that a spiral of inflation is set up. If in such conditions prices are not prevented from rising, the costs continue going up and the profitability of investment declines, so that investment stops or decreases. Only in the case of a moderate rise in prices is this spiral avoided and investment encouraged. Therefore, price rise due to deficit financing must be prevented from becoming inflationary.

*(iii) Forced savings*. When inflation occurs as a result of deficit spending, consumption must decline as a result of rising prices and, therefore, savings become forced. But it is important to remember that inflation reduces compulsorily the consumption of only fixed income earners; the consumption of higher income groups generally increases during the same period.

*(iv) Change in the pattern of investment*. Investment caused by inflation may not be of the pattern sought under the Plan. There are certain fields of investment which receive strong encouragement from inflation. Three such fields are : inventory holding, luxury, urban construction and foreign assets. These are not necessarily the best fields in planned development. Moreover, the tendency to speculation is also strengthened. Thus, deficit financing leading to inflation may encourage types of investment which are not desirable for a developing economy.

*(v) Credit creation by banks*. Inflationary forces created by deficit financing are reinforced by increased credit creation by banks, increase in government spending without a corresponding decrease in private spending raises the bank deposits with the Central bank. The commercial banks, therefore, find their liquidity increased and are in a position to make extra advance. Boom conditions in the economy and considerable scope for speculative gains increase the demand for bank credit. The increased bank credit then adds to the inflationary pressures started by deficit financing.

Deficit financing could be a helpful device and a valuable instrument in promoting economic development in an under-developed country in the initial stages. The increase in the volume of money (because of deficit financing) results in higher demand for labour and other resources. As such, deficit financing is regarded as a good tool to activise a backward and developing economy. But extreme caution is necessary in using deficit financing for economic development. For, it is intrinsically inflationary in character, and hence, proper controls are necessary. Besides, experience of other countries clearly shows that deficit financing may lead to excessive printing of currency notes which will greatly reduce the value of money. Deficit financing, like fire, is a good servant but a bad master. This is exactly what has happened in our country. With the lone exception of B.R. Shenoy, (during the formulation of the Second Plan). Indian economists at one time praised the virtues of deficit financing.

## 9. CENTRAL GOVERNMENT BUDGET (2011-12)

### Report card of the Indian Economy

Recently Central Statistical Organisation (CSO) has published statistical data for the last quarter of the year 2011-12. According to the results published, CSO has reduced the growth estimates for the year 2011-12 to 6.5 percent. In each of the preceding two years, GDP growth rate was recorded at 8.4 percent annually. No eyebrows were raised, as CSO reduced the estimates of growth rate as results were not encouraging in the last two quarters. Almost all sectors of the economy have shown decline in growth rate. As compared to 7 percent growth in 2010-11, agriculture has shown only 2.8 percent growth rate in 2011-12. In mining sector rate of growth has turned negative one percent, which was 5 percent last year. Manufacturing sector has been showing discouraging result in each successive quarter and annual growth has been estimated at 2.8 percent for 2011-12. Better growth is recorded in electricity, gas, water supply etc. Service sector has maintained good results even this year. Statistics of GDP growth indicates clearly towards spoiling health of the economy.

Economic Survey 2011-12 states, "managing growth and price stability are the major challenges of macroeco-

CHAPTER 55

# GOVERNMENT SUBSIDIES IN INDIA

*Subsidies are akin to steroids as prescriptions. Lazy doctors like to administer to their ignorant patients a dose of steroids to remedy the proximate cause of illness. Steroids provide quick relief but don't promise an enduring cure.*

— **Kishore Jethanandanini**

## 1. NIPFP PAPER ON SUBSIDIES (1997)

In his budget speech for 1996-97 Mr. P. Chidambaram, Finance Minister promised to bring out a discussion paper on subsidies. The Finance Minister placed before the Parliament the discussion paper entitled *'Government Subsidies in India'* in May 1997.

The estimation of subsidies is based on a standard classification relating to subsidies into three categories (i) Public goods, (ii) merit goods and (iii) non-merit goods.

The best examples of public goods are national defence, police, general administration. Since these services are available to all, they are normally characterised by non-rivalry and non-excludability in consumption, as observed by P. Samuelson. Since these services are available to all citizens, they do not exclude any one. Thus, such goods cannot be priced and hence are not included in the calculation of subsidies.

The second category of goods are called 'merit goods'. Examples of such goods/services are inoculation against infectious diseases, environmental protection and minimum level of education (primary education), for all. The social benefit resulting from these goods/services is much greater than the sum of private benefits to individual consumers. This is because these goods contain elements of 'externality' beneficial to the society as a whole. Other examples of merit goods are roads and bridges, flood control and research pertaining to agriculture, space, atomic energy, etc. The availability of benefits in the form of externality justifies the subsidies on these goods.

The third category of goods are non-merit goods and in their case, the benefit of subsidies accrues to the individual consumers. In case of non-merit goods, the cost of providing the commodity/service to the society is higher than the price fixed for providing it to the consumer. These subsidies result in the transfer of benefits to the individual consumer in a number of ways :

**(i) Cash subsidies** — Providing food or fertilisers to the consumer at prices lower than those at which the government procures the commodities.

**(ii) Interest or credit subsidies** relate to loans given at rates lower than market rates. This takes the form of concessional credit to small scale industries or priority sector loans to individuals to buy a taxi, an auto-rickshaw or to set up some small enterprise by buying some equipment.

**(iii) Tax subsidies** can be in the form of tax exemption of medical expenses, postponing collection of tax arrears.

**(iv) In-kind subsidies** — provision of free medical services though government dispensaries, provision of equipment to physically handicapped persons.

**(v) Procurement subsidies** — a good example is the purchase of foodgrains at an assured price which is higher than the prevailing market price.

**(vi) Regulatory subsidies** — fixation of prices of goods produced by the public sector at less than the cost with a view to providing inputs to industry or helping certain other categories of consumers. Examples are making steel, coal or other minerals available to industry, providing electricity to farmers at a rate much lower than the cost.

There is a consensus on the provision and continuance of subsidies on merit goods since the overall benefit to the society in the form of externalities is much larger. However, the provision of subsidies on non-merit goods has come in for sharp criticism since in their case, the benefits accrue to the individual while the costs are borne by the society. Moreover, in several cases, instead of the intended beneficiaries, the benefits are appropriated by better-off sections. For instance, it is alleged that benefits of the provision of cheap electric energy to farmers are, by and large, appropriated by rich and affluent farmers. Similarly, better off sections may take advantage of a generalised scheme of public distribution of foodgrains or other essential commodities.

After detailing these three categories the Discussion Paper of NIPFP concludes :

(a) Public goods like defence, general administration are not amenable to usual pricing mechanisms and therefore subsidies are not relevant for this category.

(b) Merit goods include, *inter alia*, primary education, public health, sewage and sanitation, many social welfare schemes, soil and water conservation, agricultural research, flood control and drainage, roads and bridges and scientific research. The economic case for subsidising "merit goods" is the strongest.

(c) The rest are categorised as other (non-merit) services. Some of the known subsidies like food, fertiliser and education beyond elementary level are not counted in the group of merit services. In food and fertiliser, the element of externality is limited. In such cases, justification for subsidies may have to be on grounds other than strong externality, viz., social and equity objectives. Education beyond the elementary level also falls outside the ambit of merit category.

## Estimate of subsidies

The Finance Minister's estimate of subsidies is focused on budget-based subsidies. The estimation of budgetary subsidies are computed *as excess of the cost of providing a service over the recoveries from the service.* These costs have been taken as the sum of: (i) revenue expenditure on the concerned service; (ii) annual depreciation on cumulative capital expenditure for the creation of physical assets in the service; and (iii) interest costs (computed at the average rate of interest actually paid by the respective governments), of the cumulative capital expenditure, equity investment in public enterprises, and loans given for the service concerned including those to public enterprises.

While calculating subsidies in public enterprises, in some cases, recoveries were higher than the costs. Such enterprises generated surplus. The surplus of public enterprises has to be deducted from the aggregate of subsidies so as to obtain the net estimate of subsidies.

**TABLE 1 : Finance Ministry's Estimates of Aggregate Subsidies in India : 1994-95**

₹ crores

| | Total Cost | Toal Receipts | Subsidies/Surplus | | Recovery Rate % |
|---|---|---|---|---|---|
| | | | Amount | % of total | |
| | (1) | (2) | (3) = (1–2) | (4) | (5) = ((2)1×100) |
| **I. Centre** | | | | | |
| a. Merit Goods/Services | 7,094 | 171 | 6,923 | | 2.41 |
| b. Non-merit Goods/Services | 41,113 | 4,988 | 36,125 | 38.4 | 12.13 |
| c. Surplus Sectors | 26,118 | 30,720 | -4,602 | -4.9 | 117.62 |
| d. Non merit Subsidies (net of surplus) (b+c)) | 67,231 | 35,708 | 31,523 | 33.5 | 53.11 |
| **II. States** | | | | | |
| e. Merit Goods/Services | 28,567 | 297 | 28,270 | | 1.04 |
| f. Non-merit Goods/Services | 72,772 | 6,752 | 66,020 | 70.3 | 9.28 |
| g. Surplus Sectors | -561 | 2,989 | -3,550 | -3.8 | |
| h. Non merit Subsidies (net of surplus) (f+g)) | 72,211 | 9,741 | 62,470 | 66.5 | 13.49 |
| **III. All India** | | | | | |
| i. Merit Goods/Services | 35,661 | 468 | 35,193 | | 1.31 |
| j. Non-merit Goods/Services | 1,13,885 | 11,740 | 1,02,145 | 108.7 | 10.31 |
| k. Surplus Sectors | 25,556 | 33,708 | -8,152 | -8.7 | 131.90 |
| l. Non merit Subsidies (net of surplus) (j+k)) | 1,39,441 | 45,448 | 93,993 | 100.0 | 32.5 |

SOURCE : Government of India, Ministry of Finance, *Discussion Paper, Government Subsidies in India*, May 1997.

**Table 2 : Sectorwise Estimates of Non-merit Subsidies : 1994-95**

| | Centre ₹ crores | Recovery Rate | States[1] ₹ crores | Recovery Rate % |
|---|---|---|---|---|
| **I. Centre** | | | | |
| **A. Social Services** | **2,497** | **18.1** | **20,138** | **4.0** |
| (i) Education, Sports, Arts and Culture | 782 | 0.4 | 10,262 | 1.7 |
| (ii) Health and Family Welfare | 758 | 2.5 | 4,938 | 1.5 |
| (iii) Water Supply, Sanitation and Housing | 523 | 12.3 | 2,790 | 5.2 |
| (iv) Other Social Services | 434 | 51.4 | 1,503[3] | 6.6 |
| **B. Economic Services** | **33,628** | **11.7** | **31,123** | **12.9** |
| (v) Agriculture and Allied Activities | 8,214 | 4.5 | 7,925[2] | 22.7 |
| (vi) Irrigation and Flood Control | 133 | 3.8 | 12,421 | 4.2 |
| (vii) Power | 3,929 | 36.8 | 5,957 | 15.0 |
| (viii) Industries | 10,878 | 9.0 | 1,959 | 5.9 |
| (ix) Transport | 1,486 | 14.9 | 647 | 39.8 |
| (x) Other Economic Services | 4,988 | 4.5 | 2,214 | 5.32 |
| **Total** | **36,125** | **12.1** | **51,261** | **9.6** |

Note : 1. Data relate to 15 selected states for 1993-94
2. Includes rural development, co-operation and special areas programmes
3. Includes ₹ 907 crores for urban development.

SOURCE : Government of India, Ministry of Finance, *Discussion Paper, Government Subsidies in India*, May 1997.

An estimate of the aggregate budget-based subsidies in India as given in table 1 reveals that

(i) Merit goods/services subsidies, both of the Centre and State governments, for 1994-95 were of the order of ₹ 35,193 crores — ₹ 6,923 crores by the Central Government and ₹ 28,270 crores by the State Governments.

(ii) Non-merit subsidies of the Centre and State governments, aggregated to ₹ 1,02,145 crores. Adjusting for the surplus sectors to the tune of ₹ 8,152 crores, net non-merit subsidies accounted for ₹ 93,993 crores, out of which the share of the Central Government was ₹ 31,523 crores (33.5% of the total) and that of the State Governments was ₹ 62,470 crores (66.5% of the total).

(iii) The recovery rate in case of the Centre was 12.1 per cent for non-merit goods/services and that of the State Governments was 9.3 per cent. At the aggregate level, the recovery rate was 10.3 per cent.

(iv) Non-merit subsidies were 10.71 per cent of GDP and merit goods subsidies were 3.69 per cent of GDP. Subsidies on all services were 14.40 per cent of GDP.

Break-up of subsidies into social services and economic services reveals that

(i) At the level of the Centre, economic services dominate accounting for ₹ 33,628 crores i.e., nearly 93 per cent of total subsidies provided by the Centre and social services merely account of ₹ 2,497 crores i.e., 7 per cent. The recovery rate of economic services was 11.7 per cent and that of social services was 18.1 per cent.

The major beneficiaries of the Central subsidies are industries (₹ 10,878 crores), agriculture (₹ 8,214 crores), and power (₹ 3,929 crores).

(ii) At the level of the States, social services account for about 39 per cent of total subsidies and the economic services for about 61 per cent. Since education, health, water supply and sanitation are primarily the responsibility of the states, the level of subsidies is much higher in the social sector. In economic services, irrigation is the major component accounting for a subsidy of ₹ 12,421 crores, followed by agriculture and allied services (₹ 7,925 crores), and power (₹ 5,957 crores).

The recovery rate in the social services is miserably low at 4 per cent and in economic services is 12.9 per cent. Recovery rate in irrigation is as low as 4.2 per cent and in education barely 1.7 per cent.

## 2. REPORT OF THE CENTRAL GOVERNMENT ON SUBSIDIES IN INDIA (2004)

Finance Minister P. Chidambram presented the *Report on Central Government Subsidies in India* in December 2004. It is just coincidental that in May 1997, Mr. Chidambram had also presented the discussion paper '*Government Subsidies in India.*' The present report has a narrow focus on account of the following reasons. Firstly, it focuses on only Central Government subsidies and leaves out state Government subsidies. The earlier

Discussion Paper was thus more comprehensive. Secondly, while it gives a total estimate of explicit and implicit subsidies, it concentrates on a detailed analysis of only explicit subsidies which account for only 40 percent of total subsidies in 2003-04 and undertakes no analysis about the composition, structure and need for 60 percent implicit subsidies. Even in explicit subsidies, it makes a detailed, though very useful analysis of only three major subsidies on food, fertilizers and petroleum. With these limitations, it appears that the Report was intended to provide some suggestions for reducing only explicit subsidies for the 2005-06 budget, but did not make a penetrating analysis on the need for reducing overall subsidies, at the Central as well as the State level.

The Report classifies subsidies in two broad groups – merit and non-merit subsidies. Merit subsidies are further classified into Merit-I and Merit-II subsidies.

**Merit-I :** Elementary education, primary health care, prevention and control of diseases, social welfare and nutrition, soil and water conservation, ecology and environment.

**Merit-II :** Education (other than elementary), sports and youth services, family welfare, urban development, forestry, agricultural research and education, other agricultural programmes, special programmes for rural development, land reforms, other rural development programmes, special programmes for north-eastern areas, flood control and drainage, non-conventional energy, village and small industries, ports and light houses, roads and bridges, inland water transport, atomic energy research, space research, oceanographic research, other scientific research, census surveys and statistics, and meteorology.

**Non-merit:** All others.

But the classification into Merit I and Merit II loses its significances since the Report states: Subsidy reforms should aim at "limiting these two only merit I and Merit II categories while eliminating non-merit subsidies." (p.21) In case, it in intended for prioritization, even then it depends on the subjective judgment of State and Central governments. Both kinds of subsidies Merit I and Merit II are considered sacrosanct. Thus, the sub-classification into the two is of academic value.

Data provided by the Report reveals that total subsidies have grown from ₹ 36,829 crores in 1992-93 to ₹ 1,15,824 crores in 2003-04. Thus, the average annual growth rate (AGR) was 11.0 percent during the 11-year period. Out of them, explicit subsidies have increased from ₹ 11,995 crores in 1992-93 to ₹ 46,869 crores in 2003-04, indicating an annual growth rate of 13.2 percent. As a percentage of total subsidies, explicit subsidies have increased from 32.6 percent to 40.5 percent during this period. Likewise, implicit subsidies have jumped from ₹ 24,834 cores in 1992-93 to ₹ 68,955 cores in 2003-04, indicating an annual average growth rate of 9.7 percent. The share of implicit subsidies in total subsidies has, however, fallen from 67.4 percent to 59.5 percent during the period. The point which deserves attention is that the absolute size of implicit subsidies is nearly one and half times the size of explicit subsidies.

Another, interesting revelation is that in 2003-04 the share of merit subsidies in total subsidies was 42 percent and that of non-merit subsidies was 58 percent. Since subsidies are the difference between the cost of providing goods and services and the receipts obtained from the users, then it may be noted that in merit goods, the recovery rate is only 0.9 percent and in non-merit goods, it is 47.3 percent. As a policy prescription, there is a need to gradually increase the recovery rate in non-merit goods to reduce the huge outgo in the form of subsidies to this sector, but this is again a political decision that coalition government which have been in power during the last 15 years in India are unable to take due to various kinds of political pressures from different sectors of the population.

**TABLE 3. Break-up of Subsidies into Explicit and Implicit Subsidies for Selected Years**

| | Total Subsidies (₹ crore) | Explicit Subsidies (₹ crore) | Implicit Subsidies (₹ crore) | Relative Share (%) | |
|---|---|---|---|---|---|
| | | | | Explicit Subsidies | Implicit subsidies |
| 1992-93 | 36,829 | 11,995 | 24,834 | 32.6 | 67.4 |
| 1994-95 | 43,089 | 12,932 | 30,157 | 30.0 | 70.0 |
| 1995-96 | 42,941 | 13,372 | 29,569 | 31.1 | 68.9 |
| 1996-97 | 47,781 | 16,364 | 31,417 | 34.2 | 65.8 |
| 1998-99 | 79,828 | 24,786 | 55,042 | 31.1 | 68.9 |
| 2002-03 | 1,04,913 | 45,189 | 59,724 | 43.1 | 56.9 |
| 2003-04 | 1,15,824 | 46,869 | 68,955 | 40.5 | 59.5 |
| Annual Average growth rate (1992-93 to 2003-04) | 11.0 | 13.2 | 9.7 | | |

SOURCE : Compiled and computed from Table 2.1 and 2.4 of the *Report on Central Government Subsidies in India* (2004).

**TABLE 4: Relative Importance of Different Classes of Subsidies (2003-04)**

| | *Cost (₹ crore)* | | | *Receipts* | *Subsidy* | *Percentage of total subsidies* | *Recovery Rate (%)* |
|---|---|---|---|---|---|---|---|
| | *Current* | *Capital* | *Total* | *(₹ crores)* | *(₹ crores)* | | |
| | (1) | (2) | (3=1+2) | (4) | (5=3-4) | (6) | (7=4/3x100) |
| **Social Services** | **20,619** | **4,353** | **24,972** | **497** | **24,475** | **21.2** | **1.99** |
| Merit I | 6,062 | 315 | 6,377 | 3 | 6374 | 5.5 | 0.04 |
| Merit II | 6,872 | 2,960 | 9,832 | 72 | 9,760 | 8.5 | 0.73 |
| Total Merit | 12,934 | 3,275 | 16,209 | 75 | 16,134 | 14.0 | 0.46 |
| Non-Merit | 7,686 | 1,078 | 8,763 | 422 | 8,341 | 7.3 | 4.82 |
| **Economic Services** | **1,13,129** | **38,142** | **1,51,271** | **60,170** | **9,1101** | **78.8** | **39.78** |
| Merit I | 398 | 3 | 401 | 0.0 | 401 | 0.3 | 0.00 |
| Merit II | 26,500 | 5,896 | 32,396 | 357 | 32,039 | 27.7 | 1.10 |
| Total-Merit | 26,898 | 5,899 | 32,797 | 357 | 32,440 | 28.0 | 1.09 |
| Non-Merit | 86,230 | 32,243 | 118,273 | 598.13 | 58,460 | 50.57 | 49.43 |
| **Total Social and Economic Services** | **1,33,748** | **42,494** | **1,76,242** | **60,667** | **1,15,575** | **100.0** | **34.41** |
| **Merit I** | 6,460 | 318 | 6,778 | 3 | 6,775 | 5.9 | 0.04 |
| **Merit II** | 33,372 | 8,856 | 42,228 | 429 | 41,799 | 36.1 | 1.02 |
| **Total-Merit** | 39,832 | 9,174 | 49,006 | 432 | 48,574 | 42.0 | 0.88 |
| **Non-Merit** | 93,916 | 33,320 | 1,27,236 | 60,235 | 67,001 | 58.0 | 47.31 |

**Source:** Compiled and computed from the *Report on Central Government Subsidies in India* (2004).

The share of social services which include education, health, family welfare, water supply and sanitation and labour and employment is only 21.2 percent in total subsidies, and the share of economic services, viz., agriculture, rural development, energy, industry and minerals, irrigation and flood control, science, technology and environment is 78.8 percent in the total subsidies. Although it is possible to reduce subsidies in social services to some extent by raising recovery rates in university and higher education and to some extent in some unnecessary youth and welfare programmes, but this shall have to be compensated by increasing subsidies in compulsory elementary education and expanding public health services for the poor. In short, the scope for reducing subsidies in social services in practically negligible.

There is, however, enough scope for reducing subsidies in economic services. For instance, in agriculture and rural development activities, subsidies of the order of ₹ 50,579 cores were provided in 2003-04, but recovery rate was barely 1.3 percent. Similarly, in coal and lignite which is a non-merit good, the recovery rate is only 3.3 percent. Another big area for reducing subsidies is industry and minerals which receives a subsidy of ₹ 29,532 crores and the recovery rate is only 6 percent. Besides bringing about an overall increase in recovery rate, there is a need to give pointed attention to reducing subsidies in agriculture and rural development, coal and lignite and industry and minerals. But the farm lobbies on the one hand and industrial lobbies on the other, besides the coal mafia would put up resistance. Again, the decisions have to be taken at the political level.

**TABLE 5: Central Government Subsidies (2003-04)**

| | *Cost ₹ crores* | *Subsidy ₹ crores* | *Recovery Rate (%)* | *Subsidies as percentage of* | |
|---|---|---|---|---|---|
| | | | | *Revenue Receipts* | *GDP* |
| **A. Social Services (a+b)** | **24,972** | **24,475** | **1.99** | **9.30** | **0.88** |
| (a) Merit | 16,209 | 8,763 | 16,134 | 8,341 | 0.46 |
| (b) Non-merit | 4.82 | 6.13 | 3.17 | 0.58 | 0.30 |
| **B. Economic Services (c+d)** | **1,51,519** | **91,350** | **39.71** | **34.73** | **3.30** |
| (c) Merit | 32,797 | 1,18,722 | 32,440 | 58,910 | 1.09 |
| (d) Non-merit | 50.38 | 12.33 | 22.40 | 1.17 | 2.13 |
| **C. Total (A+B)** | **1,76,491** | **1,15,824** | **34.37** | **44.04** | **4.18** |
| (e) Merit (a+c) | 49,006 | 1,27,485 | 48,574 | 67,250 | 0.88 |
| (f) Non-merit (b+d) | 47.25 | 18.47 | 25.57 | 1.75 | 2.43 |

**Note:** Memo-items for 2003-04 in ₹ crores GDP = 27,72,194 Revenue Receipts: 2,63,027

**Source:** Ministry of Finance, Government of India, *Central Government Subsidies in India* (2004).

**TABLE 6. *Explicit Subsidies in Central Budget***

| *Year* | *Food* | *Fertilizer* | *Petroleum* | *Import* | *Railways* | *Interest* | *Others* | *Total* | *Total as %age of GDP* |
|---|---|---|---|---|---|---|---|---|---|
| 1990-91 | 2,450 | 4,389 | | 2,742 | 283 | 379 | 1,915 | 12,158 | 2.1 |
| 1991-92 | 2,850 | 5,185 | | 1,758 | 312 | 316 | 1,832 | 12,253 | 1.9 |
| 1992-93 | 2,800 | 5,796 | | 818 | 353 | 113 | 2,115 | 11,995 | 1.6 |
| 1993-94 | 5,537 | 4,512 | | 665 | 412 | 113 | 1,393 | 12,682 | 1.5 |
| 1994-95 | 5,100 | 5,769 | | 658 | 420 | 76 | 909 | 12,932 | 1.3 |
| 1995-96 | 5,377 | 6,735 | | 318 | 388 | 34 | 520 | 13,372 | 1.1 |
| 1996-97 | 6,066 | 7,578 | | 397 | 468 | 1,222 | 633 | 16,364 | 1.2 |
| 1997-98 | 7,900 | 9,918 | | 429 | 536 | 78 | 644 | 19,505 | 1.3 |
| 1998-99 | 9,100 | 11,596 | | 574 | 602 | 1,434 | 1,480 | 24,786 | 1.4 |
| 1999-00 | 9,434 | 13,244 | | 520 | 685 | 1,371 | 438 | 25,692 | 1.3 |
| 2000-01 | 12,060 | 13,800 | | 621 | 812 | 111 | 867 | 28,271 | 1.4 |
| 2001-02 | 17,499 | 12,595 | | 616 | 896 | 210 | 906 | 32,722 | 1.4 |
| | (53.5) | (38.5) | | (1.9) | (2.7) | (0.6) | (2.8) | (100.0) | |
| 2008-09 | 43,751 | 76,602 | 2,852 | – | 2,346 | 3,492 | 3,009 | 1,32,054 | 2.5 |
| 2009-10 | 58,443 | 61,267 | 14,951 | 198 | NA | 2,957 | 2,958 | 1,41,351 | 2.3 |
| 2010-11 (Actual) | 63,844 | 62,301 | 38,371 | NA | NA | 4,680 | 4,224 | 1,73,420 | 2.3 |
| 2011-12 (RE) | 72,823 | 67,199 | 68,481 | NA | NA | 5,791 | 2,003 | 2,16,297 | |
| 2012-13 (BE) | 75000 | 60974 | 43580 | NA | NA | 7,968 | 2,493 | 1,90,015 | NA |

**Note:** 1. Others include grants to NAFED, debt relief and import subsidies on pulses and edible oils. to farmers and some other minor subsidies.

2. Figure in brackets indicate percentage of a particular subsidy to total in the row.

3. Data on Explicit subsidies include subsidy to railways also upto 2001-02.

SOURCE: Compiled and computed from *Report of Central Government Subsidies in India* (2004) of the Ministry of Finance, Union Budget 2010-11.

Let us examine the issues at the level of the Central Government. Of the total Central Government subsidies in 2012-13 of the order of ₹ 1,90,015 crores, food subsidy accounts for ₹ 75,000 crores (39.5%), fertilizer subsidy ₹ 60,974 crores (32.1%) and petroleum subsidy ₹ 43,580 crores (22.9%). Taking food, fertilizer and petroleum, these three subsidies account for 94.5 percent of the total explicit subsidies. Other Central Government subsidies on Railways, interest subsidy etc. account for barely 5.5 percent. Obviously, if explicit subsidies have to be reduced, then steps have to he taken to limit these three subsidies.

## Food subsidy

Food subsidy in India comprises of three components: (i) subsidies to farmers through support prices, (ii) subsidies to consumers through public distribution system, and (iii) subsidies to the Food Corporation of India (FCI) in its purchase and maintenance of buffer stocks. Data reveal that during 1997-98 and 2003-04, the Central issue price of rice was increased from ₹ 350 per quintal to ₹ 565 per quintal – an increase by 61.4 percent and that of wheat was increased from ₹ 250 per quintal to ₹ 415 per quintal – an increase by 66 percent. However, the consumers price index for agricultural labourers (CPIAL) increased by only 25.8 percent during this period. The purpose of raising the issue price at a relatively higher rate than the rise in CPIAL was to subsidize the farmers to keep foodgrains production at a comfortable level.

Since the FCI continues to purchase foodgrains without any limit, this has resulted in the creation of buffer stocks in FCI godowns far in excess of the prescribed minimum norms. Food stock reached a peak of 63 million tonnes in July 2002, more than 2.5 times the norm of 24 million tonnes. By April 2004, the stocks were brought down to 20 million tonnes, not by increasing PDS offtake of foodgrains, but by exporting foodgrains at near BPL prices. The cost of handling and carrying costs of foodgrains by the FCI over and above the minimum norm is met by the subsidy to FCI. Since FCI operations are concentrated only in five states, viz., Punjab, Haryana, Western UP, Andhra Pradesh and Chhattisgarh, the entire subsidy is available to farmers in these states only. Moreover, since the Minimum Support Price (MSP) is limited to only two crops, rice and wheat, this has distorted the cropping pattern in favour of these two foodgrains.

The Report has suggested the following policy reforms:

(i). Minimum Support Price (MSP) should correspond to CACP-determined C2 cost, which includes all cash costs and the imputed value of family labour.

(ii) Before every sowing season, food procurement targets should be fixed on the basis of norms and a margin of error of about 10 percent. FCI should suspend puchase of operations once the targets are achieved.

(iii) A system of price insurance, similar to Farm Income Insurance Program introduced recently on a pilot basis, may be developed.

(iv) FCI should include a greater number of states in their price-support operations.

(v) In order to enforce efficiency, the reimbursement to FCI should be on the basis of normative unit costs and actually involved quantity, instead of reimbursement on actual basis.

(vi) To improve PDS penetration and reduce leakages, the Government can introduce the system of food coupons for the poor. A uniform PDS price will be fixed for APL and BPL facilities, but the poor can buy foodgrains partly with coupons and partly with cash. Since the poor cannot afford monthly procurement of foodgrains in one go, the PDS purchases should be allowed only on a weekly basis. Restricting monthly bulk purchases at PDS will discourage the not-so-needy from PDS outlets. This will help self- targeting of PDS.

All these measures appear to be good intentioned. But the major problem relates to their implementation. It is said that habits die hard and hardened habits are still difficult to break. For all these years, the State has been succumbing to farm lobby pressures, thereby responding by raising the minimum support price as also undertaking unlimited procurement. With limiting PDS operations to only five states, a huge buffer stock surplus was created which the state frittered away in exports at nearly BPL prices. Now on the one hand, a proposal is made to extend procurement to more states, and on the other, to limit procurement to the procurement target fixed in the beginning of the agricultural season, appears to be a non-feasible proposition. It would have been better if the present practice of procuring foodgrains by FCI had been continued and the Government should resist further increase in MSP beyond the increase in CPIAL. At the same time, the surplus in FCI godowns should be used to guarantee employment to all unemployed by extending the provisions of the Employment Guarantee Act. Wages can be paid partly in cash and partly in kind – foodgrains. This will be a more practical way of converting food subsidy into employment. The Government will earn the goodwill of farmers as well as unemployed – landless labourers, marginal farmers, and other semi-literates in rural areas.

## Fertilizer Subsidy

Fertilizer subsidy which was ₹ 6,735 crores in 1995-96 shot up to Rs. 13,800 crores in 2000-01 – more than double the level during the five year period. Thereafter, it slightly declined and was around ₹ 12,000 crores in 2003-04. As a proportion of GDP, fertilizer subsidy which was only 0.23 percent in the early-1980s increased to a peak of 0.93 percent in 1989-90 and thereafter, it started to decline. It was barely 0.53 percent in 1993-94. In the subsequent period, reversal of trend occurred, it reached a level of 0.68 percent in 1999-00, but had declined since then to an estimated level of 0.43 percent in 2003-04. In 2010-11 (BE) fertilizer subsidy has been kept at ₹ 49,981 crores.

Fertilizer subsidy is the difference between the retention price of fertilizers and the price at which fertilizers are made available to consumers. The difference is paid to industry as subsidy. A serious attempt was made by the Government to reform the Retention Price Scheme (RPS) so as to rationalize fertilizer subsidies. Government decontrolled the import of phosphorus and potassium fertilizers and provided a flat-rate concession on their imports. But urea imports continued to be restricted and canalized. In 2000, on the recommendation of Expenditure Reform Commission (ERC) a group-concession rate scheme was introduced on 1st April 2000. ERC recommended phasing out of the unit-wise RPS in stages over a period of six years.

Studies have revealed that overall, for the entire period of 1981-82 to 2002-03, the average share of farmers in fertilizer subsidy was 62 percent and that of industry was 38 percent. Any scheme of rationalization of fertilizer subsidy depends on two factors: (i) efficiency of domestic fertilizer industry and the domestic cost of production, and (ii) the international price of urea. In the event of opening up of fertilizer sector imports, the gas-based plants would survive, whereas others, particularly naphtha-based plants, would not. This is due to the fact that naphtha or fuel oil or low sulphur feedstock is more costly as a raw material than natural gas.

The Report suggests that there is a need to reduce the subsidy to farmers as well as industry. In the short run, the subsidy may be continued. But in the long run, the option of setting up fertilizer plants in such countries where natural gas is available in plenty may be considered. Secondly, there is a need to increase the farm-gate price of urea at regular intervals. The Report is of the opinion that the application of fertilizers is "more dependent on technological and non-price factors than on price or agro-economic variables. These factor include irrigation facilities, cropping pattern, spread of high yielding varieties (HYVs), effective fertilizer distribution and availability of credit." The Report, therefore, is of the view that increase in urea prices may not translate into lower production. It recommends public investment as "an effective instrument to promote the use of fertilizers." Moreover, rationalization of urea price would have a salutary impact on balanced application of N (Nitrogen), P (Phosphate) and K (Potash).

## Petroleum Subsidies

Two major components of petroleum subsidies are (a) subsidy for kerosene for domestic use and (b) LPG subsidy due to the difference between international price and the price at which it is supplied to consumers. On account of the unprecedented rise in the international prices of crude and petroleum products, there is an explicit increase in the subsidy bill in the Central Governement's budget from ₹ 5,225 crores in 2002-03 to ₹ 3,108 crores in 2010-11 (BE). Discussing the policy options, the Report mentions: "LPG subsidy benefits largely the higher expenditure groups in the urban areas, and may be regressive." (p.19) Consequently, the Government can legitimately increase the LPG prices to reduce its subsidy bill consequent upon a steep rise in petroleum crude prices world over. "With regard to kerosene, on a per capita basis, the urban areas receive a larger subsidy. The limited availability of subsidized kerosene in rural areas biases its use in favour of lighting rather than cooking. Moreover, the kerosene subsidy in rural areas is regressive as higher expenditure groups receive more subsidized kerosene than lower expenditure groups. Kerosene subsidy is prone to misutilization with about half the subsidized kerosene supplies diverted and never reaching the intended groups." (p. 19) To improve the targeting of this subsidy to the poor, the Report suggests that "coupons may be issued only to poor ration card holders with entitlement to purchase kerosene from a retailer at subsidized price." (p. 19)

The upshot of the analysis is that subsidies can be reduced if the Government has the political will to undertake hard decisions. But coalition government which try to appease various social groups find it extremely difficult to do so. There is a large gap between policy and practice. The scheme of distributing food coupons or kerosene coupons to the poor appears to be good, but the question is: Do we have an administrative system which is decidedly pro-poor? Or even if the job of distributing coupons is left to panchayats or local MLAs, shall it result in achieving the desired objective? It would be better to distribute coupons to families whose children get education in State primary schools or who avail of the facilities of primary health centres. A system of identification of poor has to be evolved, or else even the coupon method would lead to heavy misutilization. Besides this, the Government should present a discussion paper on implicit subsidies and find out mechanisms of reducing them. There is a big scope in this area.

However, enunciating The Policy of the Government, the Finance Minister in his Budget speech on February 28, 2005 mentioned: "Subsidies provide a measure of protection for poor and we shall continue to provide subsidies". Obviously, the political economy of subsidies prevents the government not to go ahead with a policy of reduction of subsidies. A blanket statement of this kind prevents even the of restricting of subsidies which benefit the better-off sections of society.

Though we find actually significant amount of subsidies per petrolem product is the recent years, but the same is not getting reflected in the budget, as this has been financed by issue of oil bonds by public sector oil companies. These bonds are supposed to the redeemed from the profits of public sector oil companies.

## 3. FUTURE POLICY ON SUBSIDIES

It is now really over a decade that a comprehensive paper on subsidies was presented by National Institute of Public Finance and Policy (NIPFP) in 1997. The situation has changed drastically since then and there is a need to re-examine the issue. The main reasons are :

1. Implicit subsidies in various forms are growing both at the Central and State levels. Take for instance, the large number of tax exemptions on Special Economic Zones (SEZs) granted by the Government. They imply a big loss of tax revenues. Another instance is the role of the state governments in acquiring land for SEZs and passing on to industrial houses.

West Bengal in its drive for industrialisation agreed to the following subsidies on its Singur project to the Tatas. The land at Singur has been provided by the Government to the Tatas on a 90-year lease, with no downpayment. Secondly, for the first five years, Tatas will pay ₹ 1 crore as rent and the yearly payment will increase by 25% for each year interval for five years for the next 25 years. For the next 30 years, payment will increase by 33% at a five year interval and for the final 20 years, the rent would be ₹ 20 crore per year. The West Bengal Government also agreed to provide a loan to the Tatas of ₹ 200 crores at 1 percent rate of interest while the VAT proceeds accruing from the sale of cars will be handed back to the Tatas against 1% loan for the first 10 year period. But as against this, the total compensation to the farmers will be of the order of ₹ 200 crores.

The question raised by the critics of industrialisation paradigm of development is : Are we following a policy of inclusive growth by taking away the livelihoods of farmers, sharecroppers and other associated persons dependent on land? On the other hand, are we providing heavy subsidies of several kinds — land acquisition and development by the Government on behalf of industry, subsidised power, generous tax holidays, financial support for purchase of equipment, subsidised credit and exemption of waiver from exports etc. to industrialists.

Similarly, the state governments have been providing free or highly subsidised electricity for agriculture which benefit mainly the rich farmers.

It has been estimated that various kinds of tax exemptions have resulted in revenue foregone to the tune of ₹ 2,78,644 crores – a colossal sum indeed. The Government has been praising the corporate sector for better tax compliance resulting in a sharp increase in corporation tax revenues, but facts as they stand, reveal that although notionally, the corporation tax rate is 33%, its effective rate is only 19%. This sharp reduction in effective rate as against the prescribed rate of 33% is the result of the plethora of exemptions granted to the corporate sector.

2. There is a need a consider the legitimacy of other subsidies as well which fall in the category of non-merit subsidies.

3. There is a tremendous change in the situation with respect to petroleum subsidy since international price of crude petroleum has crossed $ 110 per barrel. If the government provides the subsidy fully to oil companies, then the subsidy amount is likely to reach 1.5 lakh crores this years. As a consequence, the fiscal deficit could be pushed up by an additional 3.2% of GDP. The Government could partially salvage the situation by providing 50% subsidy in the form of bonds and thus, only the interest on bonds will be reflected in the budget as a cost. But when the bonds mature at a future date, their redemption will exercise pressure on the fiscal deficit.

The situation in case of fertilizer subsidies is no better. The international price of fertilizers is 4-5 times the domestic price. The likely impact of fertilizers subsidy is going to be ₹ 80,000 crores as against the provision of ₹ 31,000 crores in 2008-09 budget.

A similar situation prevails in food subsidies. The international price of foodgrains has also risen sharply. On account of shortage at home, India has decided to import one million tonne of foodgrains so that the weaker sections of society are provided foodgrains at subsidized rates. Thus, the foodgrains subsidy bill will be much higher than the provision in the 2008-09 budget of the order of ₹ 32,667 crores.

The Finance Minister made a provision of ₹ 66,537 crores in the budget for 2008-09 – for food subsidy ₹ 32,666 crores, for fertilizers ₹ 30,986 crores and for petroleum for ₹ 2,885 crores. But both national and international factors are going to jeopardise these predictions. Even by issuing bounds to some public sector companies for petroleum subsidy, the country shall be only postponing a part of the burden for future years. Despite this, experts estimate that the total subsidy on food, fertilizers and petroleum products is likely to go up to 4-5% GDP. The situation is, therefore, very grim.

But what are the policy options? Firstly, the Government has no option but to accept the subsidy on petroleum imports. It can further increase the domestic price of petroleum products. Even if this is done, it will only reduce the burden of the Government partially. The option of reducing petroleum imports is not available to the Government in view of expanding demand for petroleum due to sharp increase in the growing demand and production for automobiles — motor cycles, three wheelers and cars. Secondly, in case of food and fertilizers, the chances of charging the consumers more appear to be very bleak since the coalition government has to face the electorate in the General Election due in early 2009. Thirdly, the Government has to take a decision about the large scale exemptions granted to industry so as to enchance its revenues. But in view of the commitment made on SEZ projects, the Government requires great amount of courage to slash down exemptions.

The only policy option available with the Government is to present a comprehensive paper on all subsidies – Central as well as state levels, both implicit and explicit. It is quite possible that a national debate on the question of subsidies may result in throwing up a consensus on some short-term and some long-term options to reduce the mounting burden of subsidies.

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CHAPTER 53

# FINANCIAL RELATIONS BETWEEN THE CENTRE AND THE STATES

*"The Centre-State relations are crucial to the preservation of the unity and integrity of India within the framework of its linguistic, cultural and other diversities."*

**—West Bengal Government Document**

## 1. FINANCIAL RELATIONS UNDER THE CONSTITUTION

India has a federal structure, in which a clear distinction is made between the Union and State functions and sources of revenue, but the residual powers belong to the Centre. Although the States have been assigned certain taxes which are levied and collected by them, they also share in the revenue of certain Union taxes, and there are certain other taxes which are levied and collected by the Union but the proceeds of which wholly go to the States. In addition, the States receive grants-in-aid of their revenue from the Union which further increase the amount of transfers between the two levels of governments. The transfer of resources from the Central Government to the States is an essential feature of the present financial system of India .

### Division of Resources

The Constitution of India makes a clear division of fiscal powers between the Union (on the centre) and the State Governments. The principle adopted for this classification is that taxes which have an interstate base are levied by the Union, while those with a local base are levied by the States. The residuary powers belong to the Union.

The Union taxes as laid down in List I, Seventh Schedule of the Constitution of India, are as under :—

1. Taxes on income other than agricultural income, 2. Corporation tax, 3. Customs duties, 4. Excise duties except on alcoholic liquors and narcotics not contained in medical or toilet preparations. 5. Estate and succession duties other than on agricultural land, 6. Taxes on the capital value of assets, except agricultural land, of individuals and companies, 7. Rates of stamp duties on financial documents, 8. Taxes other than stamp duties on transactions in stock exchanges and future markets, 9. Taxes on sale or purchase of newspapers and on advertisements therein, 10. Taxes on railway freight and fares, 11. Terminal taxes on goods or passengers carried by railways, sea, or air, and 12. Taxes on the sale or purchase of goods in the course of inter-State trade.

Taxes within the jurisdiction of the States as given in List 11 of the Seventh Schedule of the Constitution of India are as follows :—

1. Land revenue, 2. Taxes on the sale and purchase of goods, except newspapers, 3. Taxes on agricultural income, 4. Taxes on land and buildings, 5. Succession and estate duties on agricultural land, 6. Excise on alcoholic liquors and narcotics, 7. Taxes on the entry of goods into a local area, 8. Taxes on mineral rights, subject to any limitations imposed by Parliament, 9. Taxes on the consumption and sale of electricity, 10. Taxes on vehicles, animals and boats, 11. Stamp duties except those on financial documents, 12. Taxes on goods and passengers carried by board or inland waterways, 13. Taxes on luxuries including entertainments, betting and gambling, 14. Tolls, 15. Taxes on professions, trades, callings and employment, 16. Capitation Taxes, and 17. Taxes on advertisements other than those contained in newspapers.

The Union and the State Governments have concurrent powers to fix the principles on which taxes on motor vehicles shall be levied and to impose stamp duties on non-judicial stamps. The property of the Union is exempted from State taxation and the property and income of the State are exempted from Union taxation. The Parliament may, however, pass legislation for taxation by the Union of any trading or business activities of a State which are not part of the ordinary functions of the Government. States may delegate part of their taxation power to the Central Government, as had happened in the case of agricultural land being included in the purview of the Estate Duty Act in many States. Parliament has exclusive power to tax sales or purchases of goods in the course of inter-State trade.

The Union Government has exclusive power to impose taxes which are not specifically mentioned in the State or Concurrent Lists.

Thus, the Indian Constitution, being federal in character, has indicated the nature and scope of functions of the Union and State Governments and also the taxes allocated to them. At the same time, the framers of the Indian Constitution were aware that the allocation of financial resources did not correspond with the assigned functions and that the resource gap in the States might widen over the years. Accordingly they provided for the distribution or devolution of financial resources from the Centre to the States. It was specifically for this purpose that Article 280 provides for the setting up of a Finance Commission by the President of India every five years or earlier.

## Distribution and Allocation of Central Revenue

Apart from the taxes levied and collected by the States, the Constitution had provided for the revenues for certain taxes on the Union list to be allocated, partly or wholly, to the States. These provisions fall into various categories.

There are, in the first place, certain duties which are levied by the Union but are collected and appropriated by the States. These include stamp duties and excise duties on medical preparations containing alcohol or narcotics.

Secondly, there are certain taxes which are levied and collected by the Union, but the entire proceeds of which are assigned to the States, in proportion determined by the Parliament. These taxes include succession and estate duties, terminal taxes on goods and passengers, taxes on railway freight and fares, taxes on transactions in stock exchanges and futures markets, the taxes on the sale and purchase of newspapers and advertisements therein.

Thirdly, Central tax on income and Union excise duties were levied and collected by the Union but were shared by it with the States in a prescribed manner.

Finally, the proceeds of additional excise duties on mill-made textiles, sugar and tobacco, which were levied by the Union in 1957 in replacement of States' sales taxes on these commodities, are wholly distributed among the States in a manner as to guarantee their former incomes from the displaced sales taxes.

***Grants-in-aid.*** As important welfare and development functions are entrusted to the States, gaps between their revenues and expenditure have to be corrected through transference of resources from Centre. This is done partly by arrangements for tax sharing. But grants-in-aid by the Union for specific purposes or general aid have come to occupy an important place in Union-State financial relations in India. The grants also serve the purpose of correcting inter-State disparities in resources. They also help in the exercise of a certain measure of central control and co-ordination over essential welfare services and development programmes in different states.

***Loans.*** The States are authorised to raise loans in the market but they also borrow from the Union Government which gives the latter considerable control over State borrowing and expenditure. The rate of annual borrowing by the States from the Union has considerably increased during recent years. Borrowing is made among other purposes for irrigation and river programmes, agricultural development, community development and industrial housing.

## Resources Transferred to the States

The importance of Central contributions to State resources becomes clear from Table 1 showing the transfer in broad categories since the inception of economic planning.

The figures indicate the rising contribution of the Centre to State resources. On an average, the States received ₹ 280 crores per year from the Centre during the First Plan, ₹ 3,020 crores per year during the fourth plan, and ₹ 21,000 crores per year during the the Seventh Plan.

During the first plan, 36 per cent of the State expenditure was met by resources transferred by the Centre. Currently, transferred resources from the Centre

**TABLE 1. Gross Devolution and Transfer of Resources from the Centre to the States**

*(₹ crores)*

| | Shared Taxes | Grants | Loans (net) | Total | Transferred Resources as percentage of States' total expenditure |
|---|---|---|---|---|---|
| 1951-52 | 50 | 30 | 70 | 150 | 25 |
| First Plan (1951-56) | 340 | 290 | 800 | 1,430 | 36 |
| Second Plan (1956-61) | 670 | 790 | 1,430 | 2,870 | 42 |
| Third Plan (1961-66) | 1,200 | 1,300 | 3,100 | 5,650 | 43 |
| Fourth Plan (1969-74) | 4,560 | 3,830 | 6,710 | 15,100 | 37 |
| Sixth Plan (1980-85) | 23,730 | 15,470 | 14,120 | 53,320 | 46 |
| Seventh Plan (1985-90) | 49,460 | 42,810 | 31,260 | 1,23,530 | 46 |
| For the period (1990-95)* | 98,890 | 90,720 | 54,650 | 2,44,260 | 43 |

SOURCE : *Report of the Twelfth Finance Commission* (2005-10) and other Finance Commissions

pay for 46 per cent of the total expenditure of the States. The growing transference of resources from the centre to the states is evidence of: (a) increasing integration between the Central and State finances; (b) helpless dependence of States on the Centre; and (c) growing power and interference of the Centre in the affairs of the State.

## 2. THE FINANCE COMMISSION AWARDS

Under the provisions of Article 280 of the Constitution, the President is required to appoint a Finance Commission for the specific purpose of devolution of non-Plan revenue resources. The functions of the Commission are to make recommendations to the President in respect of

(i) the distribution of net proceeds of taxes to be shared between the Union and the States and the allocation of share of such proceeds among the States,

(ii) the principles which should govern the payment by the Union of grants-in-aid to the revenues of the States, and

(iii) any others matter concerning financial relations between the Union and the States.

The appointment of the Finance Commission is of great importance, for it enables the financial relation between the Centre and the units to be altered in accordance with changes in need and circumstances. The elasticity in relationship introduced by this provision has great advantage.

12 Finance Commissions have so far been appointed by the Government since the inauguration of the Constitution in 1951. The recommendations of the Finance Commissions can be grouped under three heads—

(a) Division and Distribution of income tax and Central excise duty, additional excise duty in lieu of sales taxes and

(b) Grants-in-aid and

(c) Centres' loans to States.

The Tenth Commission (TFC) presided over by K.C. Pant recommended an alternative devolution of Central taxes. This necessitated a Constitutional amendment under which the proceeds of all Central taxes were shared with States. The Eleventh Finance Commission (EFC) and the Twelfth Finance Commission have followed the new system of sharing and accordingly we have summarized their recommendations separately. The following summary of sharing revenues between the Centre and States relate to only the first ten Finance Commissions.

### (a) Division and Distribution of Income Tax

The personal income tax is imposed and collected by the Union Government but the net proceeds are shared between the Centre and the States under Article 270 of the Indian Constitution. The Finance Commissions have to give their award on two points :

(a) the share of the States in the total collection of income tax (this is known as vertical division) and

(b) the principle/principles which should govern the share of each State in the divisible pool (this is konwn as horizontal division of resources between states).

### Vertical division of Income Tax

The First Finance Commission (presided over by J.P. Neogi) recommended that the States should share 55 per cent of the proceeds of the income tax. But the successive Finance Commissions had raised the States' share in income tax to the level of 85 per cent (Seventh, Eighth and Ninth Finance Commissions). However, the Tenth Finance Commission in its report for the period

1. The recommendations of the Eleventh and Twelfth Finance Commission are elaborately dealt with separately in the next section.

1995-2000 recommended that 77.5 per cent of the net proceeds of taxes on income should be assigned to states.

### Horizonatal division of income tax proceeds

As regards the basis for the distribution of the States' pool of income tax proceeds among the States, the first few commissions had used the double criteria of population and tax collection.

The First Finance Commission, for instance, recommended the allocation of income tax proceeds on the basis of 80 per cent and 20 per cent for population and collection. This criterion benefited populous states as well as those richer states which contributed more income tax revenue. The Second Finance Commission regarded population of a State as a more important basis for distribution and, accordingly, awarded that 90 per cent of the States' divisible pool of income tax should be distributed on the basis of population. This criterion naturally favoured populous states like Uttar Pradesh and Bihar which were the poorest states in India. This was reversed by the Third and Fourth Finance Commissions which raised the share of collection to 20 per cent and thus gave greater share to States like Maharashtra and West Bengal which contributed most of the collection of income tax (because of the location of metropolitan cities like Bombay and Calcutta). From the Fifth Commission onwards, population had again become the major criterion for distribution of income tax proceeds among the States.

For the first time, the Eighth Finance Commission presided over by Y.B. Chavan, introduced a new formula for distribution of the income tax proceeds among the States :

(a) 10 per cent would continue to be distributed among the States on the basis of collection of income tax;

(b) 90 per cent of the proceeds of the income tax would be distributed among the States on the following criteria :

25 per cent on the basis of population;

25 per cent on the basis of inverse of the per capita income of the state multiplied by population; and

50 per cent on the basis of the distance of the per capita income of a state from the highest per capita income state (i.e., Punjab) and multiplied by the population of the State.

The basic objective of this three-factor formula was to bring about a high degree of equity among the States. The Ninth Finance Commission (NFC) basically followed the above formula with minor modifications.

The Tenth Finance Commission (TFC) evaluated the formula of both Eighth and Ninth Finance Commissions and introduced the following formula/criteria to determine the shares of the different States in the shareable proceeds of income tax:

(a) 20 per cent on the basis of population of 1971;

(b) 60 per cent on the basis of distance of per capita income of a State from that of the State having the highest income;

(c) 5 per cent on the basis of area adjusted;

(d) 5 per cent on the basis of index of infrastructure; and

(e) 10 per cent on the basis of tax effort.

**Table 2. Recommendations of Finance Commissions on Income Tax**

| *Finance Commission* | *State share of income-tax (per cent)* | *Distribution of income-tax to the States on the basis of* | |
|---|---|---|---|
| | | *Population and other criteria* | *Tax contribution* |
| First | 55 | 80 | 20 |
| Second | 60 | 90 | 10 |
| Third | 65 | 80 | 20 |
| Fourth | 75 | 80 | 20 |
| Fifth | 75 | 90 | 10 |
| Sixth | 80 | 90 | 10 |
| Seventh to Ninth | 85 | 90 | 10 |
| Tenth | 77.5 | 90 | 10 |

Source : *Finance Commission Reports*

It would be clear from the above table that (a) the successive finance commissions, except the Tenth, had increased the share of the States in the income-tax levied and collected by the Centre, and (b) the proceeds are shared among States mainly on the basis of population, economic backwardnes and other criteria.

## (b) Division and Distribution of Excise Duty

**Vertical division.** The First Finance Commission selected three excise duties—on tobacco, matches and vegetable products—for division with the States, so as to give them larger revenues. These commodities are widely consumed and yield a substantial revenue to the Government. The Commission recommended 40 per cent of the net proceeds of these duties to be distributed among the States on the basis of population. The Second Finance Commission added to the list of duties shared between the Union and the states, but reduced the share of the States from 40 per cent to 25 per cent. The Third Finance Commission increased the number of excisable commodities in the divisible pool from 8 to 35 by including all commodities on which duties were collected in 1960-61 but reduced the States' share from the divisible pool from 25 per cent to 20 per cent. The Fourth Finance Commission enlarged the list to 45 commodities, but the share of the duties was retained at 20 per cent. The Fifth and Sixth Commissions did not make any change.

The Seventh Finance Commission, however, raised the States' shares to 40 per cent of the net proceeds. The Eighth Commission raised the States' share to 45 per cent and distributed 40 per cent on the basis of a new formula—the same as for income tax—and 5 per cent to deficit states. The Ninth Finance Commission proposed to distribute the entire amount of 45 per cent as a consolidated amount without dividing it into two components of 40 per cent and 5 per cent.

Finally, the Tenth Finance Commission has raised the share of the states in the net proceeds of union excise duties to 47.5 per cent. This rise in the States' share in excise duties is to compensate for the reduction in their share in come tax.

**TABLE 3. Recommendations of Finance Commissions on Excise Duty**

| | | Distribution of Excise Duty | |
|---|---|---|---|
| *Finance Commissions* | *States' Share of Excise Duty* | *on the basis of population* | *on the chasis of backwardness of States the per centage of the poor in the statse etc.* |
| First | 40% of 3 duties | 40 | 60 |
| Second | 25% of 8 duties | 40 | 60 |
| Third | 20% of 35 duties | 40 | 60 |
| Fourth & Fifth | 20% of 45 duties | 80 | 20 |
| Sixth | Do | 75 | 25 |
| Seventh | 40% of all duties | 25 | 75 |
| Eighth & Ninth | 45% of all duties | 25 | 75 |
| Tenth | 47.5% of all duties | 20 | 80 |

SOURCE : *Finance Commission Reports*

It is necessary to emphasise here that all finance commissions kept one basic objective, that is, *to increase the share of the States in the proceeds of Central excise duties*. The first few finance commissions brought in more and more central excise duties under the divisible pool, but reduced the percentage share of the States. The Seventh, and subsequent Finance Commissions, however, have

(a) brought *all* the Central excise duties under the divisible pool; and

(b) raised the share of the States from 20 per cent to 40 per cent and then finally to 47.5 per cent.

Thus, over the years, Finance Commissions have increasingly relied on Union Excise Duties in meeting the revenue needs of the States.

## Horizontal division.

As regards the horizontal distribution of the proceeds of Central Excise Duties among States, the Finance Commissions had initially adopted two criteria, viz., the population of the State and the backwardness of the States. This system of distribution clearly favoured populous but economically backward states like Uttar Pradesh and Madhya Pradesh.

The Seventh Finance Commission was the first to introduce a new formula for distribution of the States' share of the Central excise duty: 25 per cent weightage equally to (a) population, (b) increase in the per capita income of the state, (c) the percentage of the poor in each state, and (d) a formula for income equalisation between states.

The Ninth Finance Commission (NFC) recommended the following method for distribution of the net proceeds of the Union Excise Duties among the States:

(a) 25 per cent should be distributed among the States on the basis of 1971 population;

(b) 12.5 per cent should be distributed among the States on the basis of Income Adjusted Total Population (IATP)

(c) 12.5 per cent should be distributed on the basis of index of backwardness;

(d) 33.5 per cent should be distributed on the basis of distance of the per capita income of a State from that of the State having the highest per capita income i.e. Punjab; and

(e) the remaining 16.5 per cent should be distributed among the States with deficits, after taking into account their shares from income tax, excise duties and other shareable taxes.

The Tenth Finance Commission used the same formula prepared for the sharing of income tax for sharing the proceeds of 40 per cent of excise duties among the states as well. The remaining 7.5 per cent is distributed among deficit states.

## (c) Additional Excise Duties in lieu of Sales Tax

Apart from the usual excise duties, the Central Government has been levying additional excise duties on sugar, tobacco, cotton fabrics, woollen fabrics and man-made fabrics--these goods were declared to be goods of special importance in inter-state trade and commerce. This scheme of levying additional excise duties on the above goods was the outcome of an agreement reached at the meeting of the National Development Council (NDC) held in December 1956, by which the States agreed to refrain from exercising their power to levy sales tax on these commodities in lieu of a share in additional excise duties to be levied by the Centre. Accordingly, since 1957, the Centre has levied and collected these additional excise duties and the entire proceeds (after deducting the share of Union territories) are distributed among the States in accordance with the principles of distribution laid down by the Finance Commissions from time to time.

The Second, Third, Fourth and Fifth Finance Commissions adopted a procedure under which they first

(a) set apart the guaranteed level of States' revenue which the States were realising from sales tax on these commodities in 1956-57 and then (b) the balance amount of additional excise duties was distributed among the States according to specific principles. The Finance Commissions adopted such criteria as

(a) Percentage increase in the collection of sales tax in each State since 1956-57; and

(b) size of population of each State.

The Sixth Finance Commission made a departure from the earlier practice of first setting apart a minimum guaranteed amount for each State and then distributing the balance—the Commission was convinced that the share of each State would always exceed the revenue they would have realised in 1956-57 from the respective sales taxes on these commodities.

As regards the basis of distribution, the Sixth Finance Commission took the view that the additional duties of excise were levied in lieu of sales tax, which was itself a tax on consumption, the shares of various states should correspond to their shares in the consumption of these commodities. However, the Commission felt that reliable consumption figures were not available and, accordingly, it took State domestic product (SDP) and population as reliable approximation of consumption levels. Besides, the Commission also felt that the States would have realised sales tax not merely on what was consumed in the State but also on what was produced in the State and sold in the course of inter-state transactions of these commodities. Hence, the Sixth Finance Commission allocated the shares of additional duties on excise on the basis of population, State domestic product (SDP) and production in the ratio of 70 : 20 : 10. The subsequent finance commissions accepted this principle with minor modifications.

### (d) Grant in lieu of Tax on Passenger Fares

Article 269 of the Constitution empowers the Government of India to levy and collect taxes on railway fares and freights but the net proceeds are to be assigned to the States. This tax was first imposed in 1957 and the proceeds were distributed to the States. The tax was repealed in 1961. Actually, the tax on passenger fare was merged with the basic fare and the system of grant was introduced to compensate States for the consequential loss of revenue. The tax on passenger fare was revived in 1971 but was again repealed in 1973. Now, the Finance Commissions were given the responsibility to suggest the grants to be made to the States in lieu of the tax on passenger fares. There are two points to be decided:

(a) what should be the volume of grant the Centre should transfer to the States in lieu of the tax on passenger fares, i.e., should it be a fixed amount or should it be a fixed percentage of the total passenger earnings; and

(b) What should be the basis of inter-state sharing of the grant?

On the first question, there has always been differences between the Centre and the States. At the time the tax on passenger fare was repealed, it contributed 10.7 per cent of the non-suburban railway passenger earnings. Accordingly the States have insisted that the grant should be pegged at 10.7 per cent of the railway passenger earnings at all times. On the other hand, the Railways have always insisted that the quantum of grant should be fixed as a given amount. This amount was originally fixed at ₹ 23 crores. The Railways' case for a fixed amount of grant was based on the following arguments:

(a) The impact of social obligations has been rising continuously and the annual loss to the Railways by way of subsidisation of passenger fares and tariff on low-rated commodities was around ₹ 2,000 crores. In other words the Railways have been subsidising not only passenger traffic but also freight traffic.

(b) Railway receipts should not be treated on par with Central Government tax revenues, part of which devolves on the States. The Railways – being a major public utility undertaking – have to find adequate resources to provide a modern and efficient transport infrastructure to meet the demands of a growing economy which is acquiring further complexity and sophistication. Accordingly, increasing the amount of grant in lieu of the tax on passenger fare beyond the current size would put their development efforts at jeopardy.

The Eighth Finance Commission rejected the argument of the Railways and raised it to ₹ 95 crores which was actually 10.7 per cent of the railway passenger earnings at that time.

However, the Ninth Finance commission (NFC) accepted the Railways arguments that the latter could not bear the burden of 10.7 per cent incidence of the grant on non-suburban passenger fares but at the same time the NFC would not like to peg the quantum of grant at ₹ 95 crores. Hence, the Commission fixed the grant of a lump sum of ₹ 150 crores per annum for the Eighth Plan period of 1990-95.

The Tenth Finance Commission – like the Eighth Finance Commission – rejected the Railways argument but agreed with the views of most States , namely, the grants should be equal to 10.7 per cent of the non-subrban passenger earnings. As the total non-suburban passenger earnings for the latest available year (1992-93) was ₹ 3,540 crores, the TFC recommended 10.7 per cent of ₹ 3,540 crores, viz., ₹ 380 crores to be paid to the States annually for the period 1995-2000.

As regards the inter-state distribution of the grant in lieu of the tax on passenger fares, the Seventh Finance Commission adopted the formula of distribution of the grant in proportion to the non-suburban passenger earnings from traffic originating in each State. As the taxable event was the payment of fare, the States should get the grant on the basis of the fare paid within their boundaries. The subsequent Finance Commissions accepted the logic of this basis and adopted the formula propounded by the Seventh Finance Commission.

### (e) The Estate Duty

The estate duty was levied by the Centre in 1953 but the proceeds were to be assigned to the States. The Second Finance Commission recommended that one per cent of the net proceeds should be assigned to the Union Territories and balance to be divided among the States. The Fourth Finance Commission, however, recommended that two per cent of the proceeds of the estate duty should be assigned to Union Territories and the balance to be distributed among the States on the same basis as before. The Seventh Finance Commission recommended that the distribution of the net proceeds of estate duty in respect of property other than agricultural land should be in proportion to the gross value of all property located in each state. Meanwhile, the Estate Duty has been discontinued from 1985.

### (f) Grants-in-aid to the States

List II of the Seventh Schedule of the Indian Constitution has entrusted important welfare and development functions to the States but the various tax resources provided to the States in the Constitution were found to be inelastic and wholly inadequate. It was to overcome this problem that the Constitution provided for a mechanism of grants from the Centre to the States. Grants-in-aid may take the general form of aid to overcome current revenue deficits or to correct inter-state disparities in resources. Grants-in-aid may be for specific purposes such as the promotion of education in a backward state or for toning up of administration, and so on. Under Article 275 of the Constitution, the Finance Commissions have to decide about the grants-in-aid to states corresponding to each five year plan. A summary of the recommendations of the Finance Commissions on the grants-in-aid is given below :

| Finance Commission | Grants-in-aid |
|---|---|
| First | (i) for 7 states, to cover their deficits during the period 1951-56 |
| | (ii) for 8 states to improve primary education facilities |
| Second | Larger grants-in-aid for meeting developmental needs of States |
| Third | (i) ₹ 550 crores to all States except Maharashtra to cover part of their revenue expenditure |
| | (ii) ₹ 45 crores for improvement of communication |
| Fourth | ₹ 610 crores to cover deficits during the period, 1966-71 |
| Fifth | ₹ 638 crores to cover deficits during the period, 1969-74 |
| Sixth | ₹ 2,510 crores for 14 out of 21 States to cover their non-Plan deficits during the period, 1974-79 |
| Seventh | ₹ 1,600 crores to cover deficits of a few poor states during the period 1980-85 and also to upgrade the standard of administration |
| Eighth | A small grant of ₹ 1,556 crores for the period 1985-90 to cover deficits. |
| | A grant of ₹ 915 crores to certain states to upgrade the standard of administration. |
| Ninth | (i) Grant of ₹ 15,017 crores to cover deficits on Plan and non-Plan revenue account during 1990-95 |
| | (ii) A special annual grant of ₹ 603 crores towards the Centre's contribution to the Calamity Relief Fund—totalling ₹ 3,015 crores for the 5 year period, 1990-95 |
| | (iii) A grant of ₹ 122 crores to Madhya Pradesh towards the expenditure on rehabilitation and relief of victims of Bhopal gas leak. |
| Tenth | (i) grant-in-aid of about ₹ 7,580 crores to cover deficit on revenue account during 1995-2000 |
| | (ii) upgradation grants of about ₹ 1,360 crores for such selected items as police, fire services, jails, promotion of girls' education, additional facilities for upper primary schools, drinking water facilities in primary schools, etc; |
| | (iii) grants of about ₹ 1,250 crores to solve special problems of States; |
| | (iv) Calamity relief of ₹ 4,730 crores; |
| | (v) grants of ₹ 5,380 crores to local bodies, viz., Panchayats, and municipalities. |
| Eleventh | (i) ₹ 35,359 crores (i.e. 8 percent of 100 transfer) goes to meet the revenue deficit of States. |
| | (ii) ₹ 7,793 crores was kept for upgradation of administration and special problems associated with some states. |
| | (iii) Total grant of Rs 10,000 crores for the |

5 year period out of this panchayats would receive annually ₹ 1600 crores per annual municipalities would receive ₹ 400 crores per annum.

(iv) ₹8,256 crores for relief during calamties

(v) Thus in total grants in aid of ₹ 58,587 crores was recommended by the commission.

The total amount of grants provided by the Tenth Commission would come to Rs 20,300 crores.

It will be observed from the above summary of recommendations regarding grants-in-aid, that every finance commission—till the Sixth Finance Commission—increased the amount of grants-in-aid to the States. There were two basic reasons for this :

First, the finance commissions realised that the States required increasingly larger resources to meet their ever-growing expenditure on law and order, welfare and development.

Second, despite larger transfer of tax resources to the States, the latter were incurring huge revenue deficits.

Accordingly, the successive finance commissions awarded larger grants to be made by the Centre to the States. The Seventh and Eighth Finance Commissions, however, reversed this trend by providing for larger devolution of tax revenues to States :

(a) raising the share of the States in income tax proceeds from 80 per cent to 85 per cent;

(b) bringing all central excise duties under tax sharing, instead of only 45 duties; and

(c) raising States' share in excise duties from 20 per cent to 40 per cent and eventually to 45 per cent.

As a result of these awards, there was such a large devolution of tax revenue to the States that most of them got surpluses on revenue account. The Ninth and Tenth Finance Commissions calculated non-Plan deficit as well as Plan deficits of States during the periods (1990-95 and 1995-2000).

### (g) Loans by the Centre to the States

The Second Finance Commission was asked to go into the question of Centres' loans to States which were mounting, as for instance, from ₹ 195 crores in March, 1951 to ₹ 900 crores by March 1955. The Second Finance Commission recommended that the States should be entitled to only two loans a year, a long-term loan and a medium-term loan at a rate of interest approximatly equal to the rate of interest at which the Central Government was borrowing from the market.

The Fourth Finance Commission suggested the formation of a competent body to study in detail the entire problem of indebtedness of States but nothing came out of this suggestion. The Fifth Finance Commission strongly recommended that the States should, "as a matter of necessary fiscal discipline" balance their budgets and manage their affairs within the resources available to them. The Commission was of the view that overdrafts were untenable in principle and undesirable in practice, that the States should not indulge in deficit financing and that balanced budgets and expenditure-control must be the sheet-anchor of their fiscal policy. The Commission recommended that :

(i) ways and means advances should not be considered as resources;

(ii) the present position relating to limits of ways and means advances did not call for an immediate change, although the Reserve Bank should periodically review the limits;

(iii) the Reserve Bank should call upon the States to repay the advances and should stop payment of unauthorised overdrafts; and

(iv) the Centre should assist the States to clear their overdrafts and achieve fiscal discipline, provided the default was not chronic and should consider the use of constitutional power in the case of persistent, unauthorised overdrafts.

The Sixth Finance Commission made a detailed study of debt position of the States and recommended the consolidation and spreading out of repayment over 15 to 30 years.

The finance commissions only recommended writing-off of some loans and rescheduling some portion of them. The Ninth Finance Commission was against such steps and asked states to be careful and exercise restraint in incurring additional debt.

## 3. EVALUATION OF THE FIRST ELEVEN FINANCE COMMISSION AWARDS

The appointment of a Finance Commission at intervals of five years or less has great significance for the financial relations between the Union and the States. Periodic examination of the division of resources and suitable modifications in it imparts a degree of flexibility to the finance of both the Centre and the States. This flexibility is of great value in these days of changing needs and resources. The planned development of the country involves growing expenditure and, therefore, larger revenues, and an elastic system of finance is a great necessity. Through the transfer of resources from the Centre to the States, the elasticity of the Union sources of revenue is transmitted to the State finances also. The Finance Commissions help in this process by making suitable suggestions.

The general complaint against the awards of Finance Commissions is that they generally estimate revenue gaps of States (excess of revenue expenditure over their own revenues) and devise measures for 'gap filling'. In other words, the Finance Commission awards have been characterised as 'gap-filling' awards. This type of criticism may not hold good especially for the awards of Seventh and Eighth Finance Commissions. The Seventh Finance Commission was probably the first finance commission to be deeply concerned with the equitable system of federal transfers and accordingly the devolution under the Seventh Finance Commission award was twice that of the Sixth Finance Commission. The Eighth Finance Commission was also deeply concerned with the need to help the most poverty-stricken states, hill states and backward states and its award almost doubled the devolution of the Seventh Finance Commission. There was, therefore, some justification in the claim of the Eighth Finance Commission that its award was not simply 'gap-filling', but that it attempted to achieve the twin objectives of a more equal relationship between the Centre and the States and interstate equity.

In this context, a major shift in the awards of the Finance Commision from 7th to 11th Finance Commissions may be mentioned here. In their attempt to fill the resource gap of the states, the first Six Finance Commissions relied heavily on grants-in-aid to cover their revenue deficits. The Seventh Finance Commission raised the states' share in the divisible pool of taxes by (a) raising the states' share in income tax from 80 per cent to 85 per cent, (b) bringing all excise duties under the divisible pool and (c) by raising the states' share in excise duties from 20 per cent to 40 per cent. The Eighth Finance Commission further increased the states' share in excise duties to 45 percent (the additional 5 per cent to be meant for deficit states). As a result of these recommendations, the devolution of tax revenue to the states was so much that the Seventh and Eighth Finance Commissions did not find it necessary to recommend large grants-in-aid to cover the revenue deficit of States. This trend was reversed by the successive Finance Commissions and we do find sizable grants-in-aid to cover revenue deficit of the states by Ninth to Eleventh Finance Commission.

## Alternative Scheme of Vertical Devolution

The Tenth Finance Commission (TFC) made its award on the vertical sharing of taxes between the Centre and the States and the horizontal sharing of the divisible pool between the states, and grants-in-aid. More important than its award, the TFC formulated an *alternative scheme of vertical sharing* between the Centre and States which, in its opinion, was better than the present system of tax sharing. Currently, the Constitution of India provided for sharing of the taxes with the States, viz., personal income tax and Central excise duties. According to TFC, the progress of tax reforms would be greatly facilitated if the ambit of tax sharing arrangement was enlarged. This would give greater certainty of resources for both the Centre and the States.

The TFC pointed out that for 10 years (1985-95), covered by the Eighth and Ninth Finance Commission awards, tax devolution remained constant, at 85 percent for income tax and 45 percent in Central excise duties. This meant that the Central Government had not shown any interest in income tax, as its share was only 15 percent. The tax sources under Article 268 and 269 have remained unexploited and under-exploited.

The TFC pointed out that corporation tax was more buyout and besides states had always pressed all the Finance Commission to bring the corporation tax under the divisible pool. The Finance Commissions too were concerned on this point and this was one reason why they continuously raised the States share in income tax from 55 to 85 percent and their share in Central excise duty to 40 percent. In the opinion of the Eighth Finance Commission, the corporation tax had shown high elasticity and it was fair that the states should have access to such a source of revenue. The Sarkaria Commission favoured constitutional amendment to bring the corporation tax under the divisible pool.

Finally, the Rajah Cheliah *Committee on Tax Reforms (1991)* had pleaded for re-examination of the constitutional provisions of tax sharing, for in its opinion, "The task of fiscal adjustment at the Centre has been rendered more difficult because of the compulsions arising from the formula of tax sharing with the States..... At present, tax devolution to the States constitutes around 24 percent of the Gross Central Tax Revenues. With the consent and cooperation of the States, the relevant constitutional provisions could be amended to the effect that 25 percent of the aggregate revenues of the Centre shall be shared with the States. There would be certainty then for the States and the Union regarding what revenues would accrue to their respective budgets and the Centre would not have to distort it pattern of taxation by being virtually compelled to raise non-shareable taxes."

Accepting the above recommendation of the Rajah Chelliah Committee, the Finance Ministry of the Government of India requested TFC to examine the *desirability of changing the pattern of tax sharing* in such a way that the entire tax revenues of the Centre (except of course Union surcharges and cesses) become shareable. The percentage could be around 22 to 23 percent and the arrangement should remain fixed for 20 years. If this suggestion was accepted, the Indian constitution would have to be amended suitably.

The TFC considered all these point carefully and calculated the shares of the states in (a) income tax, (b) Central excise duties, (c) revenue from additional excise duties in lieu of Central sales tax, and (d) grants in lieu of tax on passenger fares for the period 1979-80 to 1994-95. The average was as follows:

| | |
|---|---|
| Seventh FC (1980-85) : | 27.28% |
| Eighth FC (1985-90) : | 25.44% |
| Ninth FC (1990-95) : | 27.26% |

TFC, therefore, recommended that

(a) The share of states in the gross receipts of Central taxes should be 26 per cent;

(b) The additional excise duties should be merged with basic excise duties and another 3 percent of the gross tax receipts of the Centre should go to the States in lieu of additional excise duties.

The TFC recommended that this arrangement – 26 percent and 3 percent of the Central tax revenues to be transferred to the States – to be provided suitably in the Constitution and should be reviewed after 15 years.

The TFC also recommended that the proceeds of taxes under Article 268 (taxes which are levied by the Centre but the States collect and appropriate the proceeds within the respective areas) should be kept out of the pool of the Central taxes. But the proceeds of the taxes under article 269 (taxes are levied and collected by the Centre but the proceeds are wholly assigned to the States) should form part of the divisible pool; this would induce the Centre to exploit these tax bases which had remained untapped for a long time.

The TFC mentioned the following three benefits from the new arrangement:

(a) With a fixed share allotted to the states in the aggregate tax revenues, the State would automatically share the buoyancy of Central taxes;

(b) The Central Government could pursue tax reforms without the need to consider whether a tax was shareable with the States or not; and

(c) In case, the taxes under Articles 268 and 269 formed part of this arrangement, there was a greater likelihood of their being tapped.

On the pattern of alternative scheme of vertical devolution, as devised by Tenth Finance Commission, Eleventh Finance Commission (EFC) recommended for enhancement of states' share in central taxes and duties from 26 percent to 28 percent. Further, the EFC noted that consequent to the 80[th] Amendment Act, (2000) to the Indian Constitution, the additional excise duties (Goods of Special Importance) Act, 1957 in lieu of sales tax on sugar, tobacco and textiles became part of the revenue receipts of the Central Government and were, therefore, shareable with the States. The EFC felt that the earlier arrangement should be reviewed and pending this review the EFC recommended that 1.5 percent of the shareable Union taxes and duties be allocated to the States separately and thus, altogether 29.5 percent of the total proceeds of Central taxes would be transferred to the States.

**Table 4 : Criteria and Weights for determining the Relative share of States**

| *Criteria* | *Tenth Finance Commission* | *Eleventh Finance Commision* |
|---|---|---|
| 1. Population | 20% | 10.00% |
| 2. Distance of per capita income of the stae from that of the State having highest per capita income | 60% | 62.50% |
| 3. Fiscal Capacity Distance | | |
| 4. Area | 5% | 7.50% |
| 5. Index of Infrastructure | 5% | 7.50% |
| 6. Tax effort | 10% | 5.00% |
| 7. Fiscal Discipline | – | 7.50% |
| **Total** | **100.00** | **100.00** |

Regarding horizontal devolution, Eleventh Finance Commission modified the formula and reduced the weightage of population from 20 percent to 10 percent and increased the weightage of distance of per capita income of the state from that of the state having highest per capita income from 60 percent to 62.5 percent. Weightage of Area and index of infrastructure was also increased, while weightage for tax effort was reduced from 10 percent to 5 percent. A new criteria namely fiscal discipline was added and a weightage of 7.5 percent was given for the same. In the process big states with lower per capita income benefitted from the recommendation of the EFC. These states are Uttar Pradesh, Bihar, Madhya Pradesh and West Bengal.

The most important determinant of the share of the States was the distance of per capita income of a particular state from that of the state having the highest per capita income. The weightage to this measure, which was 60 per cent as fixed by the TFC was raised to 62.5 per cent by the EFC. The intention of EFC was to further help the poorer States more than the richer States. Professor AM Khusro, Chairman, EFC described this as a poverty alleviation measure.

EFC, therefore, combined the measures promoting equity and efficiency, tilting the balance, in favour of equity. On this basis, Uttar Pradesh, Bihar, Madhya Pradesh and West Bengal would receive 51.3 per cent of all shareable taxes and duties. It may be mentioned that these states comprise 43 per cent of the total population of India. Obviously, relatively lower per capita income contributed to enhancement of their share.

The Eleventh Finance Commission recommended a total devolution of ₹4,34,905 crores for the 5-year period (2000-05) in the form of devolution of taxes and grants.

It may be noted that out of the total devolution of funds, the share of the taxes and duties is 86.5 per cent and that of grants is only 13.5 per cent. Out of the total grants in-aid of ₹ 58,587 crores, a sum of ₹ 35,359 crores (i.e. 8.1 per cent of total transfer) goes to meet the revenue deficit of states, a sum of ₹ 4,793 crores was kept for upgradation of administration and special problems associated with certain states.

To provide support to local bodies-at the panchayat level and municipalities at the urban level, the Eleventh Finance Commission provided a total grant of ₹ 10,000 crores for the 5-year period. Out of this, panchayats would receive annually ₹ 1,600 crores per annum and municipalities would receive ₹ 400 crores per annum.

As Eleventh Finance Commission introduced some major changes, both in vertical and horizontal devolution of central taxes and duties, it got a mixed bag of responses. It was praised for its concern for equity, but it was criticised on various counts. It gave the benefit of devolution of additional 1.5 percent devolution on account of additional excise duties levied in lieu of sales tax on sugar, tobacco and textiles to even states which do not levy these taxes. Secondly, although it recommended a ceiling of 37.5 percent of the transfer of receipt to the states (both in the form of tax devolution and grants-in-aid), centre added a provision by stating "Where this ceiling has been accepted, it does not imply the establishment of a principle of mandatory sharing of a fixed percentage of centers revenue receipt with the states." This in other words implies that centre would like to transfer below the ceiling of 37.5 percent.

By distinguishing the forward and backward states, EFC tried to help backward states and in the process forward states have incurred heavy losses. The argument of the EFC was that momentum gathered by the already prosperous states would enable them to push their economic growth further by attracting investment – both Indian and foreign, to develop their infrastructure in the newly emerging areas of Infotech and computers and this was also documented by various studies that foreign investment, lending by commercial banks and industrial finance institutions were heavily tilted in favour of the prosperous and developed states of India. It was, therefore, necessary to strengthen infrastructure and other growth elements in poorer states so that inequalities could be narrowed down. This approach of the EFC should, therefore, be appreciated rather than criticised.

Lastly, the Commission had made some recommendations which aimed at reducing the budget deficits such as widening the tax base, controlling expenditure, taxation of the fast growing service sector, user charges to be index-linked to costs, regular revision of royalties on mines, changing the composition of Government expenditure in favour of priority areas like elementary education, primary health care, water supply, sanitation and infrastructure like roads, bridges, downsizing of Government departments and public enterprises. Although all these measures were also suggested by the Central Government, the real issue was the extent to which Government could push them through.

## 4. TWELFTH FINANCE COMMISSION AWARD (2005-10)

### Terms of Reference

The Twelfth Finance Commission was constituted by the President under Article 280 of the Indian Constitution, with Dr. C. Rangarajan as chairman. This was the second finance commission after he 80th Amendment Act (2000) of the Constitution. The terms of reference of the 12th FC were the same as those of the 11th FC, except the last one which was actually added later through a special notification. The terms of reference of the 12th FC were:

(*i*) The distribution between the Centre and the States of the net proceeds of all taxes and the allocation between the States of the respective shares of such proceeds;

(*ii*) The principles which should govern

a. The grants-in-aid to the States out of the Consolidated Fund of India; and

b. The sums to be paid to the States which are in need of assistance by way of grants-in-aid under Article 275 of the Indian Constitution.

(*iii*) The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the States;

(*iv*) Review the Fiscal Reform Facility introduced by the Central Government on the basis of the recommendations of the 11th FC and suggest measures for effective achievement of its objectives;

(*v*) Assess the debt position of the States at the end of March 2004 and suggest necessary corrective measures consistent with macro-economic stability and debt maintainability;

(*vi*) Review the present arrangements as regards financing of Disaster Management; and

(*vii*) To recommend whether the non-tax income of profit petroleum to the Centre, arising out of contractual provisions, should be shared with the States from where the mineral oils are produced, and if so, to what extent.

### The Award of the Twelfth Finance Commission

While giving its award on the various terms of reference, the 12th FC had carefully considered the views of the Central and State Governments on the various items of terms of reference... *The Commission's basic objective was*

*(a) to sustain the growth momentum;*
*(b) to bring about fiscal consolidation, and*
*(c) to recommend a scheme of transfers that could serve the twin objectives of equity and efficiency.*

The transfers from the Centre to the States – in the form of tax devolutions and grants – are meant to correct both the vertical and the horizontal imbalances.

**Vertical imbalance and devolution.** In India, vertical imbalance has always existed because the Central Government has been assigned more revenues while the State Government have been entrusted with more and larger responsibilities. Accordingly, correcting vertical imbalance necessitates transfers from the Central Government to the State Governments taken together.

As in the case of the 11th FC, the 12th FC considered all the relevant factors as regards receipts and expenditures of the Centre and of the States, the level of over-all transfers relative to Centre's gross revenue receipts, the relative balance between tax devolution and grants, etc. In their presentation to the Commission, the States had demanded an increase of the shareable pool from the 11th FCs 29.5 percent to 33 percent – some states had demanded the increase up to 50 percent. The 12th FC finally decided at 30.5 percent – increase by 1 percent – this is actually to accommodate the additional excise duty in lieu of sugar, tobacco and textiles.

As regards, the over-all transfers, the 11th FC had fixed it at 37.5 percent of Centre's gross revenue receipts. The Finance Ministry had actually requested the 12th FC to reconsider this aspect of the award of the previous Commission. Accordingly, the 12th FC considered all points of view including the historical trends in devolution.

The 12th FC found that, historically, about 38 percent of Centre's gross revenue was transferred to the States, partly through the Finance Commission awards (statutory awards) and partly through Planning Commission grants and transfers through other sources. The Commission also took note of the UPA's National CMP, which, while dealing with the subject of Centre-State relations, had demanded that the share of States in the shareable pool of Central Revenues be enhanced. Keeping all these points in view, the 12th FC fixed the indicative amount of overall transfers to States in Central gross revenue at 38 percent – just 0.7 percent more than the percentage fixed by the 11th FC.

**Horizontal Sharing** – The horizontal aspect of transfers relates to the sharing of the total shareable pool between the States. If all the States in the Indian Union have the same or almost the same per capita income, and if all the States have similar fiscal capacities, the problem of transfer between the States would be simple – namely, equal per capita transfers to every State…In practice, there are considerable horizontal imbalances – States differ in area, size of population, income, tax base, forest and mineral wealth, etc. There are differential capacities and needs of the States as also differences in the costs of providing services. Horizontal imbalances have to be corrected while distributing Central resources among all the States in the country.

The 12th FC considered the recommendations of previous commissions on this point and also the memoranda submitted by various States regarding:

(a) The continuation of the use of population as a factor;
(b) The use of income distance criteria;
(c) Continuation of area as a factor; and
(d) Retaining the tax effort and index of fiscal discipline criteria.

There is no objective factor in any of the above criteria. Till now, every FC has attempted to work out different criteria and different weightages for each criterion to arrive at a reasonable degree of equalization. In practice, this is impossible to arrive at and every FC award has been criticized by those States who felt that they should have got a bigger share in the shareable Central revenue pool.

Let us take only one criterion, viz., the population factor, which is a basic indicator of need for public goods and services, and as a criterion, it ensures equal per capita transfers among all States. This was recognized by all FCs, even though, different FCs have given different weights. The 12th FC stated in this connection, "Looking at the recent periods, during the Seventh and Eighth Finance Commissions, the weight attached to population, varied between 22.5 percent to 25 percent. This weight was reduced to 20 percent by the Ninth Commission and further to 10 percent by the Eleventh Commission. We feel that a strong case exists for increasing the weight and have fixed it at 25 percent."[1] Incidentally, in their memoranda submitted to the 12th FC, different States had demanded the weightage for population to be fixed between 10 percent to 50 percent.

Ultimately the 12th FC adopted the following criteria and weights for *inter se* determination of shares of states.

| Criteria | Weight % |
|---|---|
| Population | 25 |
| Income distance | 50 |
| Area | 10 |
| Tax Effort | 7.5 |
| Fiscal discipline | 7.5 |
| Total | 100.0 |

The 12th FC concluded: "We have tried to evolve a formula that balances equity with fiscal efficiency. Equity considerations, however, dominate, as they should, in any scheme of federal transfers trying to implement the equalization principle"[2]. Under this formula, the following five States would get the largest share of the total shareable revenue.

**TABLE 6. Transfers from the Centre to the States as percentage of gross revenue receipts of the Centre (Average)**

| | Finance Commission Transfer | | | | |
|---|---|---|---|---|---|
| | *Share in Central taxes* | *Grants* | *Total Transfers* | *Grants from Planning and other transfers* | *Total transfers* |
| VII FC | 22.4 | 2.0 | 24.4 | 13.7 | 38.1 |
| VIII FC | 20.3 | 2.5 | 22.8 | 15.1 | 37.9 |
| IX FC | 21.4 | 3.4 | 24.8 | 15.5 | 40.3 |
| X FC | 21.4 | 2.3 | 23.7 | 11.1 | 35.8 |
| XI FC (first 2 years) | 20.9 | 5.2 | 26.1 | 11.2 | 37.3 |

SOURCE : *Report of the Twelfth Finance Commission*

| *State* | *% age share* |
|---|---|
| U.P. | 19.3 |
| Bihar | 11.0 |
| Andhra Pradesh | 7.4 |
| West Bengal | 7.1 |
| Madhya Pradesh | 6.7 |
| **Total** | **51.5** |

The rest of 23 states would share the balance 48.5 percent of the shareable pool.

### Grants-in-aid

As in the case of the previous FCs, the 12[th] FC has recommended non-plan revenue deficit grants, under Article 275 of the Constitution to be given to 15 States whose total non-plan revenue deficit was assessed at ₹ 56,856 crores for the period 2005-10.

The other grants-in-aid recommended by the 12 FC are as follows:

**Grants for education for 8 States** : ₹ 10,172 crores over the award period, with a minimum of ₹ 20 crores in a year for any eligible State.

**Grants for health for 7 States** : ₹ 5,887 crores over the award period, with a minimum of ₹ 10 crores in a year for any eligible State.

**Grants for maintenance of roads and bridges** : ₹ 15,000 crores over the award period.

of public buildings : ₹ 5,000 crores

of forests : ₹ 1,000 crores

**Grants for heritage conservation** : ₹ 625 crores over the award period

**Grant for specific needs** : ₹ 7,100 crores over the award period for State specific needs.

Altogether, the 12[th] FC awarded

1. *Report of the Twelfth Finance Commission* (2005-10), P. 130

2 Report of the *Twelfth Finance Commission*, 2005-10, p. 133.

Tax Devolution : ₹ 6,13,112 crores (81%)

Grants-in-aid : ₹ 1,42,640 crores (19%)

**Total : ₹ 7,55,752 crores (100%)**

## Local Bodies – Panchayats and Municipalities

For the first time, it was the 11[th] FC which was required to suggest "the measures needed to augment the Consolidated Fund of a State to supplement the financial resources of Panchayats and Municipalities. The 11[th] FC recommended a number of measures which could be taken by State Governments and local bodies for augmenting the consolidated fund of the States to supplement the resources of local bodies. These measures included assignment of land tax, profession tax, surcharges/cesses on State taxes for improving the basic civic services and taking up schemes of social and economic development. At the same time, the 11[th] FC also noted the additional burden the States had to bear while implementing the recommendations of State Finance Commissions (SFCs). Accordingly, the 11[th] FC awarded *ad hoc* annual grant of ₹ 1,000 crores for Panchayats and ₹ 400 crores for municipalties – a total of ₹ 7,000 crores for the period 2000-05.

The 12[th] FC kept the above points and, ascertained the views of State Governments, of the Ministry of Rural Development, and of the Ministry of Urban Development and Poverty Alleviation, of the Government of India. The Commission felt that there was a case to augment the consolidated fund of the states through additional grants from the Centre, keeping in view the special circumstances of the states. Besides, there was a clear need to provide an impetus to the decentralization process. Accordingly, the Commission recommended a sum of ₹ 25,000 crores for the award period, (2005-10) as grant-in-aid to supplement the resources of municipalities and the panchayats.

The 12[th] FC argued that the urban local bodies (Municipalities) had a greater access to tax and non-tax resources of their own, and therefore, it were the panchayats which required substantial support. According to the 2001

Census Report, urban population in India constituted 26.8 percent of the total population. Hence, the 12[th] FC's grant-in-aid was based on the ratio of 20:80. That is, ₹ 5,000 crores (20 percent of the grant) would go to municipalities and ₹ 20,000 crores (80 percent) would go to Panchayats. In this connection, the 12[th] FC had also recommended separately grants for maintenance of roads and buildings which include the roads maintained by the municipalities. The municipalities would thus be major beneficiaries.

The criteria used for inter-State distribution of the above grants were as follows:

| *Criterion* | *Weight (percent)* |
|---|---|
| 1. Population | 40 |
| 2. Geographical area | 10 |
| 3. Distance from highest per capita income | 20 |
| 4. Index of deprivation | 10 |
| 5. Revenue effort | 20 |
| **Total** | **100** |

The 12[th] Commission has emphasized that, of the grants allocated to panchayats, priority should be given to expenditure on the operation and maintenance costs (O & M) of water supply and sanitation and at least 50 percent of the grants provided to each State for the urban local bodies should be earmarked for the scheme of solid waste management. Besides, expenditure on the O & M costs of water supply and sanitation in rural areas and on the scheme of solid waste management in panchayats and urban local bodies should, out of the grants allotted should give high priority to expenditure on data base and maintenance of account.

## Financing of Calamity Relief Expenditure

The 12[th] FC was asked to review the present arrangements as regards financing of disaster management with reference to the National Calamity Relief Fund (CRF) and the National Calamity Contingency Fund (NCCF) and make appropriate recommendations. After a careful study of the present system of disaster management, the 12[th] FC recommended the continuance of the scheme of CRF in its present form with contributions from the Centre and the States in the ratio of 75:25. The Commission fixed the size of the CRF for the award period, 2005-10 at ₹ 21,333 crores, of which the Centre's share would be ₹ 16,000 crores and the balance would be the share of the States (₹ 5,333 crores).

The 12[th] FC has also recommended continuance of the scheme of NCCF in its present form with core corpus of ₹ 500 crores. The outgo from the NCCF may continue to be replenished by way of collection of National Calamity Contingent Duty and levy of special surcharges.

## Debt Relief to States

The 12[th] FC was asked to assess the debt position of the States as at the end of March 2004 and suggest such corrective measures, consistent with macro-economic stability and debt sustainability. The Commission estimated that at the end of March2004, the public debt of the States would amount to ₹ 7,83,310 crores. The Commission found that the previous FCs had given debt relief in various ways: -

(a) Consolidation of loans on common terms and with reduction in the interest rates in the future;

(b) Revision in the terms of repayment of loans without lowering of interest rates;

(c) Moratorium on interest payments and repayment of principal due in certain years;

(d) Write-off of loans or repayments falling due during a specified period; and

(e) Introduction of schemes of debt relief linked to fiscal performance, etc.

The 12[th] FC considered all the above measures taken by previous commissions and also the suggestions made by the State Governments in their memoranda in regard to debt relief – pleading, among other things, bringing down the interest rates on Central loans, waiver of interest, consolidation of loans, writing-off of principal, rescheduling and moratorium on repayment. The 12[th] FC recommended the following scheme of debt relief:

(a) Rescheduling of all Central loans outstanding as on end-March 2005 into fresh loans for 20 years carrying 7.5 percent interest with effect from the year a State enacts the Fiscal Responsibility Legislation.

(b) A debt write-off linked to reduction in revenue deficit of every State. The quantum of write-off of repayment would be linked to the absolute amount by which the revenue deficit is reduced in each successive year during the award period.

The twin objectives of the 12[th] FC, were to give debt relief to the States and urge them to reduce and completely eliminate revenue deficit.

## Sharing of Profit Petroleum

The 12[th] FC was asked to recommend on: "whether non-tax income of profit petroleum to the Union, arising out of contractual provisions, should be shared with the States from where the mineral oils are produced, and if so, to what extent." This, indeed was the last term of reference given to the 12[th] FC.

To appreciate this question of sharing of profit petroleum, we should have some idea of the background. In terms of Articles 294 and 296 of the Constitution of India, the ownership rights of all land and mineral resources located within the territory of a State rest with the State.

In recognition of this constitutional right, the Petroleum and Natural Gas Rules, 1959 (P&NGR) provide that a licence or lease in respect of any land vested in a State should be granted by the State Government (though, with the agreement of the Central Government) Under these provisions, royalty in respect of any mineral oil or minerals excavated will have to be paid to

(a) the States, where the lease has been granted by the States on on-shore areas; and

(b) the Centre, where the lease has been granted by the Centre, in the case of offshore areas.

Initially, two national oil companies operated and bore all the liability of paying royalties to the States at the rate of 20 percent cess, etc. After 1997, the Government of India auctioned exploration blocks to private companies to attract private investment in exploration and thus increase the production of oil. The new exploration licensing policy (NEPL) reduced the royalty from 20 percent to 12.5 percent, to the new private parties, cancelled cess, exempted imports from customs duties and gave 7-year tax holiday from the date of commencement of commercial production of oil.

States accepted NELP, but some States (Gujarat, Assam and Madhya Pradesh) asked the Central Government to share at least 50 percent of the profit petroleum under the production sharing contract (PSC).

It was the contention of the Ministry of Law, Government of India that the regulation and development of oil fields and mineral oil resources is a subject of the Central Government under entry 53 of the Union List of the 7th schedule and is clearly outside the purview of the States, even though the State Governments have been given the benefit of certain arrangements/ practices under P & NGR, such as a (a) the authority to grant licences, leases, etc. and (b) receive rents, fees, royalties, etc.

The 12th FC did not agree with this opinion of the Central Ministry of Law but was convinced that there could be no constitutional or legal objection, if the Central Government decided to share profit petroleum under PSCs.

The States have a very strong case on the basic issue of sharing of profit petroleum. The land and mineral resources belong to them. They have to spend on the development of infrastructure, provide essential public services and incur environmental costs in order to facilitate oil exploration and development. The States should, therefore, get a share in the profit petroleum under NELP, as the royalty has been reduced from 20 to 12.5 percent.

There are, however, some differences between States themselves on this question. The States with oil resources have demanded a share in the profit petroleum between 15 to 50 percent. Some non-oil producing States have, however, suggested that profit petroleum should be shared not only with the oil producing states but with all the States. In support of this point of view, they have given two interesting but relevant arguments:

(a) The profits from petroleum production – both on-shore and off-shore are in the nature of receipts under excise duties and, accordingly, should form part of the shareable pool of taxes and apportioned like all other taxes.

(b) Any profit income that accrues to the Central Government should be made a part of the total shareable pool, because profit arises from sales across the whole country and not in the States of origin alone. Therefore, profit petroleum should not be made specific to the State of origin.

After a careful analysis of all these points, the 12th FC awarded:

(i) The Centre should share profit petroleum from NELP areas with the States from where the mineral oil and mineral gas are produced and the share should be 50:50.

(ii) The revenue earned by the Central Government on contracts signed under the coal bed methane policy should also be shared with the producing states in the same manner as profit petroleum.

## Conclusion

The award of the Twelfth Finance Commission has been accepted by the Government, though in some cases, the Finance Ministry has added some conditionalties – as, for example, the total share of the States in the Central Government's gross revenue should not exceed 38 percent. The award, broadly, was on predictable lines. In going through the whole award and the arguments given by both the Centre and the States, two important points arise which will have to be discussed and solved by future commissions:

(a) The Centre has really no important functions of law and order and nation building, but the IAS bureaucrats have taken advantage of poor ministerial material, and have managed to create, expand and multiply departments just to increase Central expenditure, even in those areas which are the constitutional functions of the States. In other words, there is a legitimate case for the reduction of the Central Government expenditure. More Central revenues can and should be transferred to the States.

(b) Just as all Central taxes are being shared with the States from the 11th FC, there is a legitimate case for the sharing of all non-tax revenues also with the States.

The attitude of the Centre as *Big Generous Brother* distributing part of the common income to the poor cousins (the states) should stop. The sooner this is done, the better.

## 5. CENTRE-STATE CONFLICT ON FINANCES

In the last few decades, there has always been growing conflict and tension between the Indian Union and the States in the matter of finance. This conflict has often been aggravated by political and ideological differences between the different parties governing the Centre and the States.

The framers of the Indian Constitution provided for grants and loans so that the Centre might come to the help of those States which were in difficulty and also to bring about balanced development of the different regions. The use of grants and loans in the last 40 years or so, however, has resulted in the complete domination and control of the States by the Centre and to a certain extent, even financial irresponsibility and indiscipline on the part of the States. The enormous increase in transferred resources from the Centre to the States, the phenomenal growth in loan assistance to the states and the political pressure amounting to blackmail by the Centre through the instrument of grants have frightened the States. Hence, there has been an insistent demand for a comprehensive review of Centre-State relations in general and Centre-State financial relations in particular. The J.K. Thavaraj Committee (Report of the Taxation Enquiry Committee, Kerala Government), the Rajamannar Committee on Centre-State relations appointed by the DMK Government of Tamil Nadu and the document on Centre-State relations (1978) adopted by the West Bengal cabinet led by the CPI-M United Front—all these have the same theme viz., political and financial autonomy for the States and drastic restriction of the power and financial resources of the Centre.

### Responsibility and Resources of the Centre and of the States

According to the Constitution, the Centre has to concern itself with the most generalised features of the Indian economy such as the creation and maintenance of the banking system, railways and ports as well as facilities for national economic planning with the regulation and development of large-scale industries, exploitation of mineral resources, regulation of foreign trade, etc., besides, of course, the defence of the nation from foreign aggression. On the other hand, the States are concerned with important aspects of the life of the people, such as the maintenance of law and order, the construction and maintenance of irrigation, power, road transport, etc. the development of educational and health facilities, the promotion of primary sector such as agriculture, fisheries, forests and secondary sector viz., tiny, small and medium industries.

In order to carry out these responsibilities the Constitution provided for different types of financial resources. The Union is entrusted with taxes on personal incomes and profits of companies, excise duties and customs duties. In a rapidly developing economy, these are precisely the most productive taxes in the country. In the case of the States, land constitutes an important base of taxation. In a densely populated country like India, the volume of land coming under tax remains almost stationary. Therefore, land, as a source of revenue has been responsible for the inelastic nature of State revenues to a considerable extent. On the other hand, the various taxes on commodities and services like sales tax, State excise duties, duties in electricity rates, motor vehicles tax etc. can be quite productive.

Taxation of industrial and commercial properties has been the preserve of the Centre, and tremendous expansion in the base of industrial and commercial property, income and wealth as a result of economic development has been responsible for raising the financial resources of the Centre. At the same time while rapid industrial development boosted Central excise duty collection, expansion of imports pushed up customs duty collections. This seems to have given a buoyancy to the Central revenues which is not available to any tax head assigned to the States except sales tax.

The period since 1951 has witnessed an enormous expansion of financial powers of the Central Government whose dimensions have progressively increased in relation to the combined resources of all State Governments put together. For instance, the current tax revenues of the Centre have risen from ₹ 360 crores in 1950-51 to ₹ 65,000 crores in 1994-95 and to ₹ 5,48,120 crores in 2007-08 (budget) On the other hand, current tax revenues of the States (excluding transfers from the Centre) have risen from ₹ 280 crores in 1951-52 to ₹ 53,400 crores in 1994-95. and ₹ 2,57,250 crores in 2006-07 (budget). The rate of growth of revenues of the Centre is much faster as compared to that of the States. But then, the Centre has only limited functions to perform while the functions of the States are almost unlimited.

In a way, the Indian Constitution itself is responsible for the existence of a financially strong-Centre and weak-States. Until partition, there was a growing consensus in favour of the corporation tax and export duties to be included in the divisible pool. This was the case made out before the Sircar Committee known as the Expert Committee on Financial Provisions. It was partition which alerted the Constituent Assembly against possible dangers to the unity of India arising from the divisive forces. Its effect is reflected in the strong-Centre theme which runs through the Constitution. The financial provisions of the Constitution clearly reflect this strong-Centre bias.

## Sources of conflict listed by the States

West Bengal, Jammu and Kashmir, Punjab, Maharashtra and Southern states have generally been very agitated over the question of state's autonomy. The Centre-State conflict on financial relations is only a part of the overall Centre-State relations and the demand for political and fiscal autonomy. The sources of conflict as listed by the states, at different times, are as follows :

(i) The basic assumption of the Constitution in favour of a strong Centre and weak and dependent states is no longer acceptable and States like West Bengal insist that a strong Centre requires equally strong and autonomous States.

(ii) The nature of functions to be performed by the States and the necessity to promote cultural, linguistic and the special conditions of each State require that States should be autonomous.

(iii) Since Independence, the Centre has been gradually extending its functions in such a way as to keep the States completely dependent on it. This process has been encouraged in the first two decades after Independence by the Congress Party which was in power both, at the Centre, and at the States. The process was further strengthened during the period of Emergency, 1975-77.

(iv) The Centre has been duplicating unnecessarily a number of departments which have no real functions to perform—i.e., education, public health, etc., which are all State subjects. There is even a move that these subjects should be put on the concurrent list.

(v) The Centre has been interfering in the affairs of the State even in the field of law and order which is purely a State subject by setting up the Central Reserve Police, the Border Security Force, the Industrial Security Force, etc.

(vi) The Centre, with too little to do, is entrusted with too much financial resources while the State Governments with so many vital functions to perform are starved of financial resources.

(vii) The financial resources of the Centre are highly elastic, while those of the States are relatively inelastic. Accordingly, the States have been forced to depend upon the Centre to a large extent for their financial requirements.

## States' complaint on financial arrangements

As the share of taxes and duties was inadequate to meet the growing revenue and capital expenditure (specially before the Seventh Plan award) the States had to resort more and more to grants-in-aid and loans from the Centre. There was a growing feeling of uncertainty and indecision, loss of initiative and irritation on the part of the States. The States had become further suspicious of the behaviour and motives of the Centre on the question of raising and sharing of tax revenues with the States.

(i) The Centre had not taken sufficient initiative to impose all the taxes under Article 269 whose proceeds would go to the States.

(ii) The corporation tax was excluded from the scope of sharing with the States from the very beginning. The States felt sore because their contribution to the development of the corporate sector was quite large. For example, they incurred considerable expenditure in providing the direct infrastructural facilities like power, water, raw materials, roads, lands, etc. Besides they provide considerable financial incentives for the setting up of industries. It was therefore, fair and appropriate that the States should have a share in the proceeds of the corporation tax as well.

(iii) The Central excise duties were continuously expanded by including under them a growing number of items previously taxed by the States.

(iv) The divisible pool of excise duties was limited to basic duties and additional excise duties; the special and auxiliary duties were kept out of the divisible pool. The rates of additional excise duties which had to be shared with the States were kept low, while raising steadily the rates of excise duties and of special and auxiliary duties which were not to be shared with the States or to be shared only in smaller proportions.

(v) The railway passenger tax whose proceeds were to go to the States was abolished and the Centre fixed arbitrarily a grant in lieu of railway passenger tax. This grant was much less than what the railway passenger tax would have brought to the States.

(vi) The surcharges on income tax were imposed by the Central Government but the proceeds were not shared with the States. The Central Government raised the exemption limit of income periodically and reduced the divisible pool of income tax. The Central Government, however, did not suffer much loss, as the loss was more than offset by the increase in the surcharge.

(vii) The main source of revenue of the States has been the sales tax which accounts for 60 per cent of the States' own tax revenue. The Centre has wanted to abolish the sales tax by introducing value added tax (VAT). There were also proposals to abolish octroi duties and state excises.

Further, the Planning Commission had asked the States to raise resources by enhancing electricity charges. But in the 1978-79 budget, the Centre decided to tap this source also by imposing excise duties on electricity, thus removing the scope for raising electricity tariff by the States (this was given up later). The States were thus left with no proper resources to raise their revenues. By depending upon the Centre, the States were running the risk of losing their economic independence.

While the revenues of the States are increasing only gradually, the expenses of the States are increasing at a fast rate. For instance, state plan outlays are increasing with every five year plan. Besides, the various policies of the Central Government (monetary, fiscal and general economic policies) affect the price situation in the country. Whenever there is a rise in price level, there is naturally a demand for increased D.A. from the Government and semi-government employees. Again, the Central Government appoints Central Pay Commission to revise salaries and dearness allowances of the Central Staff. The state Governments employees too demand rise in salaries and DA parallel to Central Government staff. The Central Government has vast financial resources to meet such demands, but the State Governments find it difficult to meet such periodical demands from their staff. It is important, therefore, that the Centre consults the States before agreeing to the grant of additional D.A. and also provide resources to the States for this purpose.

Too much dependence of the States on the Centre in the form of grants-in-aid and loans has had four serious adverse consequences.

(i) The Centre could be generous or mean to the different States. Some of the States have felt it humiliating to make frequent visits to New Delhi for funds.

(ii) A second difficulty is the uncertainty in the budgeting of the States. For instance, in the absence of firm commitments of the Central Government in the matter of grants-in-aid, it is difficult for the States to decide about the various projects of development they have to undertake.

(iii) That the States are not able to fulfil the various electoral promises because of inadequacy of financial resources.

(iv) Finally, most States had resorted to unauthorised overdrafts to finance plan projects.

## Regional Imbalances as a source of Conflict

A serious complaint of some of the States like Kerala is about the regional imbalance in industrial development. The complaint is that the Centre has not used its fiscal dominance over States to correct regional imbalances. Nor has the Centre used other instruments at its disposal to narrow down the unevenness in regional development. In the absence of integrated approach to the development of the backward regions, location of the Central sector projects and even the location of private industries through licensing policy have not created much of an impression on the problem of regional imbalances. In fact, regional disparities have worsened during the plans. It was thought that the Planning Commission would bring about a closer economic integration of the country through rapid increase in national income, higher standards of living of the masses, reduction of inequalities between regions, expansion of agriculture, industry, power and transport. While some degree of economic development has been achieved in every direction, yet from the point of view of balanced regional development, planning may be said to be a dismal failure.

Now, with the acceleration of the planning process the responsibilities and commitments of States, have increased much more than their financial resources. The result was a kind of centralisation at the federal level bringing the economic functioning of the State Governments under Central directive and control through the mechaism of grants and loans. Correspondingly, the financial powers of the States are far too meagre in relation to their clearly defined responsibilities. It was really unfortunate that the framers of the Indian Constitution could not visualise the financial implications of large-scale programmes of planned development.

## The States' demand

The Rajamannar Committee on Centre-State relations (it submitted its report in May 1971) and the West Bengal Memorandum came out with a string of suggestions and recommendations aiming at autonomy of the states, consistent with the integrity of the country. The suggestions of the West Bengal Memorandum, which revived the controversy on the question, were as follows:

(i) The powers and functions of the Centre and the States should be clearly marked and specified, and if necessary, the Constitution should be amended suitably.

(ii) The Centre's jurisdiction should be restricted to defence, foreign affairs and foreign trade, communications, currency and economic co-ordination. All other powers should be exclusively reserved for the States. There should be no interference or control by the Centre in the exercise of its powers by the States.

(iii) The present instrument of Centre's control and interference in the affairs of the States viz., the Indian Administrative and Police Services, the Central Reserve Police, the Border Security Force, the Industrial Security Force etc., should be removed forthwith.

(iv) The Planning Commission and the National Development Council which have an important role in planning and economic co-ordination should be specifically referred to in the Constitution.

(v) 75 per cent of the central revenues should be automatically transferred by the Centre to the divisible pool of the States and the Finance Commission should have power only to recommend the principles for the distribution of this divisible pool among the States.

Other important suggestions made by the West Bengal Memorandum and the Rajamannar Committee on Centre-State relations included equal representation for all States in the Rajya Sabha, the maintenance of the special status of Kashmir in the Indian Union, the retention of English as the link language between the Centre and the States, the right to use mother tongue at all levels, industrial licensing to be vested with the States, except for large companies of national importance, inter-state water disputes to be settled by the Supreme Court, etc.

The problem of Centre-State financial relations has thus been a part of the general and more important problem of Centre-State relations. The West Bengal Memorandum would allow the Centre to perform only three or four functions and leave the rest of the functions to the States. The States would like to have a say, at least indirectly, even in the limited powers and functions of the Centre. For example, the States would like to influence the location and distribution of defence industries, the use of foreign exchange reserves, allocation for the projects of communication and also monetary and fiscal policies, etc. At the same time, the Centre should be left with only 25 per cent of the revenue raised while 75 per cent of the revenue should go to the States automatically. All these things clearly indicate that the ultimate intention was to have strong states and a weak and emaciated Centre.

There is also the fear that some of the States ideologically different from others might like to break away from the federation on some pretext or the other. The DMK ideology at one time, the Khalistan movement in Punjab and Assam agitation—all these had separatist tendencies. The supporters of strong states cite the example of USSR. It was the presence of a common political ideology and supreme Central authority which held together the culturally diverse antonomous States in the U.S.S.R. When the common political ideology and the strong Central authority disppeared, USSR disintegrated. State autonomy can thus be dangerous to the national integrity and India cannot be allowed to go the USSR way.

The argument that 'State autonomy' would liberate creative energies at present inhibited by constant central interference and domination and that state autonomy would promote rapid economic growth is highly questionable in the Indian context. It is the Centre's case that except for communist parties who are wedded to an economic ideology, other regional political parties are very parochial in their outlook. Most of them are financed by big business in industry, trade, transport, films, etc. They are corrupt to the core and destinies of these states are controlled by men, among whom some have very close links with smugglers and anti-social elements. These politicians cannot see beyond their noses and want to use state autonomy to further their selfish ends so as to remain in power. In any case there is no positive correlation between state autonomy and the rapid development of different states.

In this connection it should be emphasized that the States do already enjoy considerable autonomy. They have exclusive control over such key sectors as agriculture, irrigation and power, administration, social welfare, law and order etc. But not all States have performed these functions properly in any appreciable degree. The advanced states have continued to march ahead and the backward states have remained backward.

The States' complaint about inadequate financial resources and their demand for large taxation powers would sound more reasonable if the States had fully exploited the resources they command. They are not only reluctant to tax agricultural incomes but have been abolishing land levies despite the gaping deficits in their budgets. The financial difficulties thus arise in part from their own lack of political courage. It is also an accepted fact that State tax administration is hopelessly corrupt and inefficient. Still the Centre has been sympathetic to their pleas for assistance and their share of the divisible pool of Central taxes has progressively increased over the years.

States generally resort to alternative methods for overcoming their budgetary gaps and this was mostly done through grants-in-aid and loans from the Centre before 1967. After 1967, the non-Congress dominated States and even the Congress-controlled States were in a rebellious mood and they resorted to unauthorised overdrafts on the Reserve Bank, which they insisted should be converted into regular loans. In spite of pressure from the Reserve Bank, these over-drafts continued to create inflationary pressure in the economy and constituted serious financial indiscipline.

The inadequacy of financial resources was sought to be made up by the use of Central grants-in-aid. The grants-in-aid were also meant to help backward States to come up to the level of others. Besides grants, the States approach the Centre for loans and advances. The resources transferred from the Centre have accounted for over 45 per cent of the total expenditure of the States.

It is thus clear that the States have become increasingly dependent on the Centre for their expenditure. Such a dependence is the natural consequence of the enormous command enjoyed by the Centre over relatively larger and expanding revenue resources. The massive indebtedness of the States had led to a kind of creditor-debtor relationship between the Centre and the States breeding a sense of irresponsibility among the borrowing States. In a sense, the position of dependence on the Centre has suited the States well. It has enabled them to avoid taking unpopular tax measures and to attribute their inefficiency and failure to the Centre.

By 1983, the Centre-State relations were almost at a breaking point—with Khalistan demand for a separate Sikh state, and the Southern States forming a regional council, and so on. It was to settle this problem once and for all that the Central Government appointed the Sarkaria Commission, with comprehensive terms of reference covering constitutional, legislative, financial and administrative aspects of Centre-State relations.

The Sarkaria Commission submitted its report to the Government in January 1988. According to the Commission, it was necessary to preserve the unity and integrity of the country and, accordingly, the Commission rejected the various suggestions made before it either to reduce the functions of the Centre or modify them. The Commission rejected the suggestion of transfer of subjects like preventive detention, education, labour and electricity to the state list or concurrent list on the ground that it would disturb the basic scheme of the Constitution. The Commission called for a process of consultation by the Centre of all concurrent subjects. It also made a strong case for inter-state councils, for the retention of National Development Council (NDC) and for activisation of zonal councils.

In the financial sphere, the Sarkaria Commission favoured the amendment of the Constitution to provide for sharing of corporation tax between the Centre and the States but rejected all other suggestions for enlarging the divisible pool. The Commission also rejected the suggestion that the devolution of funds from the Centre to the States should be automatic. The Commission recommended the setting up of expert committees to examine taxation reforms and resource mobilisation, to study in depth the agricultural income tax and to review the loan-grant pattern. The Commission accepted that the present division of functions between the Finance Commissions and the Planning Commission as reasonable and that it should continue. However, it suggested that the terms of reference of the Finance Commission should be drawn up in consultation with the State Governments. Finally, the Commission recommended legislation to levy consignment tax and constitutional amendment to enable levy of tax on advertisements in broadcasting.

The Central Government did not accept all the recommendations of the Sarkaria Commission. In any case, the Sarkaria Commission's recommendations are not the last word on the question of Centre-State relations. The question is still wide-open. However, on the question of Centre-States financial relations, the States welcomed one recommendation of the Sarkaria Commission—viz., the inclusion of corporation tax in the divisible pool. This was a longstanding demand of the States before every Finance Commission till now. The Central Government did not accept this important recommendation because of its own heavy revenue deficits in the last few years.

However the Tenth Finance Commission (1995) suggested a vertical devolution of all Central taxes. This sugestion was accepted and 80th Amendment (2000) to the Constitution was passed. The 11th and 12th Finance Commissions have given awards under which the states share a *percentage of all the tax proceeds of the Centre*. As a consequence, to a large extent, the conflict between the Centre and the States on the sharing of Central taxes has almost disappeared. However, many serious problems still exist such as sharing of river waters. The UPA Government has proposed the setting up of a new commission on the lines of Sarkaria Commission.

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